Base erosion and profit shifting

Policy reports, Cabinet papers and regulatory impact assessments

August 2017

Prepared by Policy and Strategy, Inland Revenue, and the Treasury

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BASE EROSION AND PROFIT SHIFTING DOCUMENTS

#	Date	Type	Title and description
01	9 March 2017	Policy report	**Consultation on addressing hybrid mismatch arrangements** Report on submissions received for the Government's discussion document *Addressing hybrid mismatch arrangements* (September 2016) – for the submissions see document #21. Report number: IR2017/133, T2017/0406
02	6 April 2017	Policy report	**Cabinet paper – Foreign hybrid entity double deductions and BEPS reforms** Covering report for Cabinet paper (document #03). Report number: IR2017/237, T2017/949
03	6 April 2017	Cabinet paper	**Foreign hybrid entity double deductions and BEPS reforms** Cabinet paper with recommendations for foreign hybrid entity double deductions and BEPS reforms.
04	18 April 2017	Policy report	**New Zealand's adoption of the OECD's Multilateral Instrument** Report covering: • submissions received for the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (March 2017) – for the submissions see document #23; and • the Multilateral Instrument Cabinet paper (document #05). Report number: IR2017/260, T2017/1004
05	18 April 2017	Cabinet paper	**Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting: Approval for Signature and Ratification** Cabinet paper with recommendations on the text and agreement to sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Reference: CAB-17-SUB-0241
06	18 April 2017	Policy report	**Update on Multilateral Instrument** Report with recommendations to add additional countries to New Zealand's list of double tax agreements covered by the Multilateral Instrument. Report number: IR2017/320, T2017/1363
07	15 June 2017	Policy report	**BEPS – summary of submissions on March 2017 discussion documents** Report on the submissions received for the Government's discussion documents *BEPS – Transfer pricing and permanent establishment avoidance* (March 2017) and *BEPS – Strengthening our interest limitation rules* (March 2017). Report number: IR2017/361, T2017/1630

#	Date	Type	Title and description
08	22 June 2017	Policy report	**Base erosion and profit shifting – overview of current reports** Report with an overview of the 22 June 2017 reports about base erosion and profit shifting (documents #09, #10, and #11). Report number: IR2017/329, T2017/1578
09	22 June 2017	Policy report	**BEPS – interest limitation submissions and policy decisions** Report on submissions and policy changes resulting from the Government's discussion document *BEPS – Strengthening our interest limitation rules* (March 2017) – for the submissions see document #22. Report number: IR2017/325, T2017/1576
10	22 June 2017	Policy report	**BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions** Report on submissions and policy changes resulting from the Government's discussion document *BEPS – Transfer pricing and permanent establishment avoidanc*e (March 2017) – for the submissions see document #24. Report number: IR2017/330, T2017/1577
11	22 June 2017	Policy report	**BEPS – Recommendations on addressing hybrid mismatch arrangements** Report with recommendations on policy changes for addressing hybrid mismatch arrangements. Report number: IR2017/353, T2017/1604
12	6 July 2017	Policy report	**Cabinet paper – tax measures to prevent base erosion and profit shifting** Covering report for Cabinet paper (document #13). Report number: IR2017/410, T2017/1847
13	13 July 2017	Cabinet paper	**Tax measures to prevent base erosion and profit shifting** Cabinet paper with an overview of the three Cabinet papers recommending measures to address base erosion and profit shifting in New Zealand (documents #15, #17, and #19).
14	13 July 2017	Policy report	**BEPS Cabinet papers** Covering report for the three BEPS Cabinet papers: strengthening our interest limitation rules, transfer pricing and permanent establishment avoidance, and addressing hybrid mismatch arrangements. Note: This document includes the Cabinet papers and signed regulatory impact assessments – these are also listed individually (documents #15–#20). Report number: IR2017/429, T2017/1901
15	13 July 2017	Cabinet paper	**BEPS – strengthening our interest limitation rules** Cabinet paper on proposals for strengthening our interest limitation rules.

#	Date	Type	Title and description
16	13 July 2017	Regulatory impact assessment	**BEPS – strengthening our interest limitation rules** Regulatory impact assessment on proposals for strengthening our interest limitation rules.
17	13 July 2017	Cabinet paper	**BEPS – transfer pricing and permanent establishment avoidance** Cabinet paper on proposals for transfer pricing and permanent establishment avoidance rules.
18	13 July 2017	Regulatory impact assessment	**BEPS – transfer pricing and permanent establishment avoidance rules** Regulatory impact assessment on proposals for transfer pricing and permanent establishment avoidance rules.
19	13 July 2017	Cabinet paper	**BEPS – addressing hybrid mismatch arrangements** Cabinet paper on proposals for addressing hybrid mismatch arrangements.
20	12 July 2017	Regulatory impact assessment	**BEPS – Hybrid mismatch arrangements** Regulatory impact assessment on proposals for hybrid mismatch arrangements.
21	September to November 2016	Submissions	**Addressing hybrid mismatch arrangements** 20 submissions received for the Government's discussion document *Addressing hybrid mismatch arrangements* (September 2016).
22	March to May 2017	Submissions	**BEPS – Strengthening our interest limitation rules** 27 submissions received for the Government's discussion document *BEPS – Strengthening our interest limitation rules* (March 2017).
23	April 2017	Submissions	**New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS** 5 submissions received for the officials' issues paper New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (March 2017).
24	April to May 2017	Submissions	**BEPS – Transfer pricing and permanent establishment avoidance** 16 submissions received for the Government's discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (March 2017).

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Consultation on Addressing Hybrid Mismatch Arrangements

Date:	9 March 2017	**Priority:**	**Medium**
Security Level:	In Confidence	**Report No:**	T2017/406 IR2017/133

Action sought

	Action Sought	Deadline
Minister of Finance	**Note** the content of this report **Agree** to the recommendations in this report	21 March 2017
Minister of Revenue	**Note** the content of this report **Agree** to the recommendations in this report	21 March 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Matthew Gan	Tax Specialist, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Paul Kilford	Policy Manager, Inland Revenue	
Casey Plunket	Special Policy Advisor, Inland Revenue	

9 March 2017

Minister of Finance
Minister of Revenue

Consultation on Addressing Hybrid Mismatch Arrangements

Executive summary

Discussion document
On 6 September 2016 the Government released a discussion document seeking feedback on proposals to address hybrid mismatch arrangements in line with the recommendations in Action 2 of the OECD BEPS programme (T2016/1319 IR2016/342 refers).

Submissions and subsequent meetings
20 submissions were received on the discussion document. 6 were from corporates and financial institutions, 4 were from industry bodies, 2 were from private individuals and 8 were from professional services firms. A list of submitters is included as Appendix 1 to this report.

Following the submissions, Inland Revenue and Treasury officials have:

- met with a number of submitters to further discuss their submissions; and
- embarked on a series of five monthly workshops with Chartered Accountants Australia New Zealand and the Corporate Taxpayers Group.

We have also been discussing hybrid issues with the Australian Tax Office, the Australian Treasury and the OECD secretariat. This report summarises the submissions received and (where relevant) our initial responses to those submissions, noting that consultation is ongoing with some of these matters yet to be covered. It also seeks your agreement to the timeframes for the remainder of the policy process.

Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. However, a greater number were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

Officials' response to submissions
Nothing compelling has emerged in the course of consultation to date to suggest that full implementation of the hybrid rules generally as envisaged in the discussion document should not be pursued. We remain of the view that the proposals are likely to be in New Zealand's best interests.

Post-discussion document developments outside New Zealand
We note that since the discussion document was released, the UK hybrid rules have come into force (1 January 2017), the EU has released a binding directive which requires EU members to expand their hybrid rules so that they apply to transactions with non-EU countries (effective 1 January 2020), and Australia remains committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment). In all cases the rules as enacted or proposed are broadly those contained in the OECD's Final Report on Action 2. No other jurisdictions have proposed implementing the OECD recommendations at this stage so New Zealand may well be within the first wave of adopters. However, the countries that are adopting the rules are significant for New Zealand. For instance, they are the source of approximately 62% of foreign direct investment into New Zealand.

Just before the discussion document was released, the OECD released a Public Discussion Draft titled *BEPS Action 2: Branch Mismatch Structures*. This document discusses cross border tax mismatches arising in the context of branches. As the title suggests, the OECD sees these mismatches as part of the hybrids project (BEPS Action 2). Accordingly, although most of these mismatches were not discussed in the Government's discussion document, we seek your approval to consult with the original submitters on them as part of this project, and we expect that submitters will be comfortable with that.

Proposed path for development of policy and legislation
A number of submissions sought further consultation on the content of the hybrid rules ("what" rather than "whether"). Given the novel nature of the proposals and the fact that they will need to cover a wide range of situations and provisions, we agree that further consultation on their content would be useful. We have therefore agreed to conduct the workshops referred to above, which are currently scheduled to occur between now and June. This will help ensure that the proposals are implemented in a manner appropriate to the New Zealand context that minimises additional compliance and administration costs without discouraging productive foreign direct investment. We will prepare materials to facilitate discussion at the workshops, and to record their outcomes.

The timetable for these workshops was set before the date of the pre-election period was known. We therefore seek your views on whether we should:

- keep to the current timeframe, which would involve seeking final Cabinet approval for policy decisions during the pre-election period – probably in mid-July; or

- shorten the planned consultation timeframe so that final policy decisions can be made before 23 June. This would inevitably reduce the scope and quality of the consultation, but it would remain a useful exercise.

Officials currently consider that, if final policy decisions are made before the election (irrespective of whether this is just before or after the pre-election period commences), consulting on draft legislation over the election period would be a useful exercise. We currently envisage that the relevant legislation will form part of the first Omnibus Tax Bill following the election. Given the inevitable complexity of legislation on these issues, consultation on draft legislation would likely result in a smoother select committee process after that bill is introduced to Parliament. If you indicate you are comfortable with consultation on draft legislation, we will include a request to that effect in the Cabinet paper seeking final policy decisions.

Recommended action

We recommend that you

(a) **Note** the contents of this report.

Noted | Noted ✓

(b) **Agree** either that:

1. officials should continue to consult with submitters on the current scheduled timelines, which would result in a Cabinet paper being prepared for submission during the pre-election period;

note my comments

Agreed/Not agreed | Agreed/Not agreed

OR

2. officials shorten the current consultation timeframe so that a paper seeking final policy decisions can be considered by Cabinet before 23 June.

see my comments

Agreed/Not agreed | ~~Agreed~~/Not agreed

(c) **Agree** that officials should consult with the original submitters on the content of the OECD's discussion draft on branch mismatch structures under Action 2 of the BEPS Action Plan.

Agreed/Not agreed | Agreed/Not agreed

(d) **Agree** that officials should plan to use the election period as an opportunity to consult on draft legislation.

Agreed/Not agreed | Agreed/Not agreed

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

Matthew Gan
Tax Specialist
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy
Inland Revenue

Please proceed with consultation with an announcement in mid July.

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Please note that government continues & doesn't stop working. No such legal concept of pre-election that I'm aware of. J

Background

1. On 6 September 2016 the Government released a Discussion Document seeking feedback on proposals to address hybrid mismatch arrangements in line with the recommendations in Action 2 of the OECD BEPS programme (T2016/1319 IR2016/342 refers).

2. This report summarises the major themes of the submissions and our responses. The submissions are generally ordered from the more general and high level to the more specific.

3. Although the expected effect of the hybrid rules will generally be to simplify commercial transactions (because they will remove the incentive to undertake transactions in a more complex tax-motivated fashion), as a technical matter, their interaction with the existing tax legislation raises an unusually large number of issues, some of them very technical. Because we are continuing to consult on those technical issues, we have not dealt with most of them here. However, they will be put before Cabinet in the process of seeking final policy approval.

General submissions

4. Submissions varied significantly in responding to the proposals. Some submitters were generally supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. However, a greater number were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand. The principal reasons for this were as follows:

- The rules will increase the effective tax rate on inbound investment which is currently enjoying hybrid tax benefits, they will raise the required return from that investment, and therefore reduce investment in New Zealand.
- In many cases, these negative effects will arise with no increase in New Zealand's tax revenue. This is the case where hybrid investment into New Zealand is replaced by debt investment into New Zealand.
- The rules may change the tax treatment of genuine commercial transactions inappropriately.
- Our international tax rules are relatively robust and New Zealand is not as exposed as other countries to hybrid mismatches.
- Abusive transactions can be dealt with effectively with simpler and more targeted rules.
- New Zealand should not enact hybrid rules before international acceptance of the rules has been evidenced by enactment in other countries.

5. A submission which was made in discussions against adoption of the rules is that their effect will be to replace hybrid arrangements with funding from countries with very low tax rates, or which do not tax foreign source interest. Such arrangements will not be subject to the hybrid rules. Generally these countries are what are commonly referred to as tax havens, but they could also include more established countries with which New Zealand has a double tax treaty, such as Hong Kong and Singapore (which have territorial tax systems).

6. Officials are not convinced by the argument that the rules should not apply to inbound hybrid investment for the following reasons:

- We consider that in some instances a disallowed hybrid instrument may be replaced with equity, resulting in higher tax payments in New Zealand.
- Revenue may be raised even when the counterfactual investment is debt as hybrids often have a higher interest rate compared to ordinary debt.
- Countries that are some of our most significant inward investment sources are also implementing anti-hybrid rules. The advantages of using hybrids to invest in New Zealand will be eliminated for investors from these countries, regardless of our course of action.

7. There is some force in the argument that double non-taxation, or close to it, can be achieved using debt funding through low or no tax countries, or countries with pure territorial tax systems, and enacting anti-hybrid legislation is therefore pointless. However, in most cases there will be an additional cost to routing funding through these countries, because the interest paid will be subject to 15% rather than 10% New Zealand withholding tax. Perhaps more importantly, by pushing companies into using such countries, the negative effect of low tax jurisdictions on corporate tax revenues becomes more visible than it does with hybrids. Residence countries are able to neutralise this form of tax planning using controlled foreign company rules if they wish to do so (as New Zealand already does, and as the OECD recommends). The hybrid rules will not put an end to all tax planning using cross border transactions. But they make useful progress towards that objective.

8. The remainder of this report is dedicated to the more specific submissions received and officials' initial responses to them.

National sovereignty/loss of coherence concerns

9. A number of submitters were concerned about national sovereignty aspects of the proposals. These concerns were based on the fact that the rules mean that the New Zealand tax treatment of a cross border transaction can vary, depending on how that same transaction is treated in another country. Submissions objected to this, on the basis that it means a loss of sovereignty and that it reduces the coherence of the New Zealand tax system.

10. The first objection is without foundation. New Zealand is free to enact laws implementing the OECD hybrid rules or not as it sees fit, and is equally free to repeal them. No national sovereignty is ceded. New Zealand's tax system already contains numerous

provisions which allow foreign tax systems to affect the amount of New Zealand tax imposed on a person. Examples are the foreign tax credit rules and the rule which taxes dividends derived from foreign direct investment by New Zealanders if the dividends are deductible in another country.

11. The second objection has more substance. However, it is axiomatic that the hybrid rules will have this outcome. For the conceivable future, countries will have different rules for taxing instruments, transactions and entities. These rules will generally exhibit a high degree of coherence domestically. For example, a dividend paid by one domestic resident to another will be taxed as dividend by both parties. However, because the rules are different, they cannot be coherent in a cross border context, without some form of co-ordination such as the hybrid rules. Some payments which New Zealand treats as dividends will be treated as interest by another country, and vice versa. The effect of the hybrid rules is to introduce a different set of rules for certain cross border transactions, which increase global tax coherence by reducing double non-taxation outcomes. There is a loss of domestic consistency (since the same instrument may be taxed differently depending on the tax treatment of the foreign counterparty), but in a cross-border transaction, this is a less important concern than cross-border coherence.

12. Most importantly, the hybrid rules do not affect coherence in a purely domestic context. They will only apply in a cross border context, and only where the outcome of applying the two domestic tax systems involved produces double non-taxation. In a world where more and more business is done across borders, cross-border tax mismatches are likely to become an increasingly significant problem.

Rules will raise the cost of capital in New Zealand, in many cases without raising revenue in New Zealand

13. This submission was made by a number of submitters. It primarily focuses on the effect of the rules on inbound debt/equity hybrids, where the return on an investment in New Zealand is properly deductible in New Zealand, and properly treated as an exempt dividend or otherwise not subject to tax in the investor country. The hybrid rules will deny a deduction for the return in this case.

14. Submissions argued that this would:

- Make no difference to New Zealand's tax take. The theory is that all foreign firms wish to minimise their New Zealand tax. Accordingly, they all have the maximum amount of debt they are allowed under the thin capitalisation rules (60% of their gross assets). This being so, the response to the introduction of the hybrid rules will be to replace hybrid debt with ordinary debt, the return on which would generally be taxed in the other jurisdiction, but still deductible in New Zealand.
- Push up the cost of capital in New Zealand, because it would increase the tax imposed on the return, and therefore decrease the amount investors are prepared to invest in New Zealand.

15. As to the first submission, this theory does not seem to be supported by the facts. The average debt to asset ratio of large foreign-controlled firms in Inland Revenue's International Questionnaire database in 2015 was 26 percent (with a median of 18 percent).[1] Only 64 firms in the database, or 20 percent of the total, had a debt to asset ratio higher than 50%.

16. It does not appear to be the case that, in response to the introduction of the hybrid rules, all hybrids will be replaced with ordinary debt. Given how foreign-owned firms are currently capitalised, we consider it more likely that some portion of hybrid capital will be replaced by ordinary equity, the return on which is taxed in New Zealand.

17. Moreover, if the Government does not enact anti-hybrid rules, this could signal to the private sector that the Government has a permissive attitude towards hybrids. There is therefore a risk that some firms currently operating in New Zealand will replace part of their equity with hybrid capital because of the available tax advantages. This could have a reasonably large fiscal cost.

18. It is not necessarily the case that foreign firms do wish to minimise their New Zealand tax. The data above, showing that typical debt levels of large foreign-controlled firms are far below the New Zealand-tax minimising level of 60 percent, demonstrates this. For example, some Australian firms may prefer to pay tax in New Zealand instead of Australia. As stated in the recent Financial System Inquiry in Australia,[2] the share price of Australian firms is increasingly being set by non-resident investors, who do not benefit from franking credits, so may prefer paying tax in New Zealand, where the corporate tax rate is lower.

19. As to the second submission, submitters are correct that, in some instances, the total tax impost (i.e. New Zealand tax plus foreign tax) on investors currently using hybrids will increase. This will make New Zealand a less attractive investment location to these investors. We do not think this is a significant concern for several reasons.

20. As discussed above, we consider that if hybrid mismatches are eliminated, some hybrid capital would, be structured as equity. In these cases, the effect of the hybrid is to eliminate New Zealand tax on the investment. Neutralising hybrid mismatches will increase the total tax on investors because New Zealand tax would be payable. We do not consider that this is a problem. This treatment is in line with our general taxation settings, where we do impose a reasonable level of tax on foreign investment here. We think these settings serve New Zealand well.[3]

21. In some cases the alternative to a hybrid investment is debt, where the effect of the hybrid is to eliminate foreign tax on the investment. In this situation submitters' concern that these changes will push up the cost of capital in New Zealand has more force, as there would be no accompanying increase in New Zealand tax payments.

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[1] Based on the International Questionnaire for the 2015 income year, which has data on all foreign-controlled firms (excluding banks) with turnover of more than $80m – 314 firms in total.

[2] Financial System Inquiry Final Report (2014), available from http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

[3] The reasons for this are discussed in the joint IRD/Treasury paper *New Zealand's taxation framework for inbound investment* (June 2016).

22. However, in many situations submitters' contention that these changes will push up the cost of investing in New Zealand is incorrect. Several other countries are also enacting anti-hybrid rules, including two of our largest trading partners (Australia and the UK). Collectively, these countries account for 59 percent of total FDI into New Zealand.[4] Our own enactment of anti-hybrid rules will have no impact on the total tax impost on hybrid capital originating from these countries, as the mismatch will be neutralised regardless through the primary/defensive hybrid rules structure.

23. Even when an investor is from a country that is not enacting anti-hybrid rules, and the counterfactual investment is debt, the enactment of anti-hybrid rules is not an unambiguous loss for New Zealand. Hybrid elements frequently increase the interest rate on a financial instrument, so a switch to ordinary debt may reduce interest deductions here and accordingly increase New Zealand tax payments.

24. Nevertheless it remains the case that, in some instances, the cost of investing in New Zealand will be pushed up because of this reform without any change in New Zealand tax revenues. We consider this to be a less pressing concern for New Zealand than it would be for other countries. While FDI is generally considered highly sensitive to company taxation, we argue in our inbound investment framework that tax is much less likely to play a critical factor in investment decisions into New Zealand. This is because New Zealand is an island nation, far away from the rest of the world. Much FDI here is likely to be associated with the supply of goods and services to the domestic market, which would be difficult to do without establishing a base here.

25. In any event, there are potential indirect benefits to New Zealand from eliminating the inefficiencies that result from hybrid mismatches and the associated double non-taxation. This argument is dealt with in detail in the 2016 joint Treasury/IRD paper *New Zealand's taxation framework for inbound investment*. It is worth setting out the key passage here (see p21):

> *There are more general arguments in favour of joining a multilateral effort to remove arbitrage possibilities (which are at the heart of many BEPS issues). When companies engage in BEPS, the result is that no tax is paid anywhere on a portion of income. This clearly leads to an inefficient allocation of investment internationally as cross-border investments are subsidised relative to domestic investments. Eliminating this misallocation would increase worldwide efficiency, leading to higher worldwide incomes. The best approach for New Zealand may be to co-operate with other countries in eliminating this worldwide inefficiency in the hope of gaining its share of this extra worldwide income.*
>
> *Double non-taxation reduces company taxes worldwide. While there may be arguments that in certain circumstances the cost falls on other countries, it would be naïve to suggest that the cost never falls on New Zealand. Experience suggests that once taxation is eliminated in the residence country, source country taxation is placed at risk. For example, the BEPS-induced decline in US taxation of US residents' foreign-sourced income is often cited as a major reason for the increased focus on reducing source-country taxation by US multinationals. In*

[4] Based on 2016 data on the stock of direct investment by country, from Statistics New Zealand.

> *that case, a general move to eliminate BEPS possibilities would make tax collections in all countries, including New Zealand, more secure and less vulnerable to unexpected tax planning.*

26. Moreover, quite random reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment in New Zealand and lead to complex arrangements that are themselves a source of inefficiency. Identifying these situations, or designing rules that turn off our anti-hybrid rules in them, would be difficult. Such an approach could also be questioned by our trading partners – the tax advantages conferred by hybrids are, by definition, not intended by either country.

27. There is a broad public concern that BEPS is unfair. Large companies escaping tax while earning substantial profits in a country has been the subject of considerable public controversy. Overall there are strong arguments for considering initiatives in this area. An important priority for the Government is considering rules to address BEPS.

28. Given all of this, we remain of the view that implementing anti-hybrid rules with a general application remains in New Zealand's best interests.

Rules should be limited to deal with NZ-specific hybrid concerns

29. In favour of this submission, submitters pointed to the fact that the rules are relatively complex and have the potential for overreach. They said that many of the structures considered in the Final Report have not been seen in New Zealand, and therefore do not need to be counteracted.

30. We agree that the rules are complex, which is part of the reason we are conducting a series of workshops on technical aspects of the rules to minimise the risk that they reach further than they should. However, on balance, we do not think a partial approach would serve New Zealand well. The rules are a coherent package. Indications from other countries adopting the rules are that they will adopt all of them, subject only to relatively minor modifications. It will be preferable for New Zealand to do the same. This should reduce the need to make subsequent piecemeal amendments. It will also ensure our rules are internationally comparable. If an element of the rules were deliberately omitted from New Zealand's response, this might be seen as a tacit blessing of that type of mismatch, inviting undesirable tax planning, with all the attendant risk of disputes and law changes.

31. Lastly, while New Zealand almost certainly has not experienced all of the types of transactions considered in the Final Report, there is no doubt that New Zealand taxpayers have engaged in complex cross border tax planning, and that the structures entered into would have engaged most, if not all, of the proposed rules if they had been in force.

Rules should not be enacted until more widely adopted

32. Some submitters suggested that it would not be sensible for New Zealand to be an early adopter of the hybrid rules, and that we should wait for other countries, in particular Australia, to adopt them first. It was not altogether clear in some cases why early adoption was seen as undesirable. It could be because:

- If another country already has the rules, their adoption by New Zealand will have no impact on the taxation of hybrid arrangements between New Zealand and that country. If another country does not, then adoption of the rules by New Zealand will be the event that eliminates the tax benefit of such arrangements. This is simply an argument against the adoption of the rules, and is dealt with in the remainder of this report.
- If another country does not have the rules, it may be a more attractive investment destination than New Zealand, at least for investment from other countries that do not have the rules.
- Even if another country has the rules, they may not be implemented in a pure and consistent way based on the OECD recommendations and/or other countries will have other features in their overall tax regimes so that they remain internationally attractive to multinational groups. New Zealand will benefit from waiting and seeing how the rules are adopted in larger economies.
- If New Zealand waits to introduce the rules until they are more globally adopted, businesses will be more familiar with them, and New Zealand will be perceived as less of a special case.

33. The most obvious response to this submission is that in fact, the rules are being widely adopted, and by many countries with which New Zealand has close investment links. Australia, the UK and the countries making up the EU account for approximately 62% of the direct investment into New Zealand.

34. Leaving that aside, officials note that:

- The hybrid rules work to neutralise mismatches involving the tax base of a country that adopts them regardless of their adoption by any other country.
- Since Australia is also adopting the rules, there is less downside, from a "favourable destination for investment" perspective for New Zealand from doing so. Adoption of the rules will not make New Zealand a less favourable destination for our largest source of direct investment, nor will it make New Zealand a less favourable investment jurisdiction than Australia.
- In relation to certain double deduction structures involving Australia[5], if Australia adopts the rules and New Zealand does not, that might well be to the detriment of the New Zealand tax base. This might also be the case in other situations.
- There is no evidence that the existence of hybrid mismatches has led to any investment in New Zealand that would be at risk if they were eliminated.

[5] Double deduction Australian limited partnership structures.

- While acknowledging it may be safer to see how the detail of the rules is implemented in other jurisdictions, there is an advantage to New Zealand in being in the leading group of adopters, particularly with Australia. New Zealand has the chance to have some influence in how the rules are implemented around the world, we are able to benefit from engaging with other countries who are also actively engaged in developing their rules (particularly the case with Australia) and it may also prove possible to introduce our rules in a more co-ordinated fashion with Australia.

35. We note that since the discussion document was released, the UK hybrid rules have come into force (1 January 2017), the EU has released a binding directive which requires EU members to expand their hybrid rules so that they apply to transactions with non-EU countries (effective 1 January 2020), and Australia remains committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment). In all cases the rules as enacted or proposed are broadly those contained in the OECD's Action 2. No other jurisdictions have proposed implementing the OECD recommendations for hybrids at this stage.

Compliance cost concerns

36. There is no doubt that the need to comply with the hybrid rules will involve some additional cost for business. There will be the initial cost of helping to develop and understanding the rules, and then the cost of ensuring that they are complied with. However, in the vast majority of cases, compliance costs can be minimised by not entering into, or unwinding, hybrid structures, and replacing them with structures that in most cases are commercially much simpler and cheaper, albeit less tax effective.

37. The imported mismatch rule was a particular target of this submission. We appreciate the concerns raised here as the imported mismatch rule applies where the hybrid mismatch does not directly involve New Zealand, and serves as an integrity measure for some of the other OECD recommendations for hybrids. Prima facie it will require corporate groups to identify hybrid mismatches which are not subject to direct counteraction, and then to determine how the benefit of such mismatches should be apportioned between payments that are subject to the imported mismatch rule, which could involve multiple jurisdictions.

38. The cost of compliance with this rule is reduced by the fact that it does not apply to payments made to other countries which have hybrid rules. Accordingly it will not apply to payments by a New Zealand resident to (for example) an Australian one (assuming Australia adopts the rules), and adoption of the rules in New Zealand will ensure that compliance costs in respect of this rule do not arise in respect of payments from countries which have hybrid rules to New Zealand. If New Zealand is within the first wave of adopters, there will be additional compliance costs as it waits for other countries to come on board, particularly so if New Zealand introduces the rules before Australia (although this is not expected on current timelines).

39. We envisage that as a practical matter, the kinds of multinational groups where imported mismatches might conceivably apply will employ skilled tax managers, one of

whose tasks will be to review the existence of mismatch arrangements throughout the group. The introduction of hybrid rules by other countries means that this task will be required to be performed regardless of whether or not New Zealand has hybrid rules.

40. The workshops with submitters on technical aspects of the rules are intended to ensure that compliance and administrative costs do not become an undue burden on businesses or Inland Revenue. Imported mismatches will be covered through the upcoming workshops and we will report back on this matter as part of final policy recommendations.

Effect on taxation of foreign branches of New Zealand companies

41. A number of submitters argued that the adoption of recommendation 6, denying the ability of New Zealand companies to use foreign branch losses to reduce New Zealand taxable income, meant that New Zealand should revisit its current system of taxing the business income of foreign branches. Indeed, some submissions argued that an exemption for active income of a foreign branch should be enacted regardless of whether the hybrid rules proceed.

42. This proposal was considered and rejected in an earlier Cabinet paper (T2013/2166 PAS2013/162). If the hybrid rules were to proceed on the basis set out in the preceding paragraph, there would be a good argument in favour of revisiting the proposal.

43. However, the OECD is in the process of modifying its published position on this point. It now recommends that foreign branch losses be non-deductible in the head office country only if the losses are used in the branch country to reduce the tax on income which is not taxed in the head office company. For many ordinary businesses, this will not be the case, and therefore the adoption of the modified recommendation 6 will not affect their ability to use their foreign losses against New Zealand taxable income.

44. Accordingly, we recommend at this stage that the hybrid project proceed without considering the general tax treatment of foreign branch income and losses. However, this issue could be considered in the near future if the Government wished to revisit it, subject to resource constraints.

Branch mismatches

45. On 22 August, the OECD released a Public Discussion Draft titled *BEPS Action 2: Branch Mismatch Structures*. This document discusses cross border tax mismatches arising in the context of branches. As the title suggests, the OECD sees these mismatches as part of the hybrids project (BEPS Action 2).

46. The branch mismatches in the Discussion Draft are analogous to those considered in the Government's September discussion document. They involve deductible/non-includible, double deduction, or imported mismatches. The only difference is that these mismatches arise

because of differences in countries' rules for taxing branch income, rather than because of differences in how countries tax entities or instruments.

47. The counteractions proposed in the Discussion Draft are also of the same nature as those proposed in relation to hybrid mismatches.

48. Officials are of the view that these mismatches also need to be considered. We note that the UK's hybrid rules deal with branch mismatches, and that UK officials have stated that without this, the rules would have been much easier to circumvent.

49. Officials believe it will be much better to consider branch mismatches in the context of the current consultation. Accordingly, we propose to discuss them at our meetings in mid/late March with the Corporate Taxpayer Group and Chartered Accountants Australia and New Zealand. We will also approach the New Zealand Law Society and the New Zealand Bankers' Association and offer them the opportunity to consider the branch mismatch issues. Apart from some individuals who submitted on the Government discussion document, these four groups represent all of the original submitters. We expect submitters will be comfortable with this approach.

De minimis rule

50. Four submissions supported a de minimis rule either generally, or specifically for the imported mismatch rule, to reduce compliance costs. One supported consideration of a general de minimis rule, but was concerned about possible complexity in the rules to show that that the de minimis could be relied upon. The submitter noted the imported mismatch rule (recommendation 8) as a place where a de minimis might be particularly useful. Two suggested a general de minimis so the rules would only be targeted at higher value transactions (e.g. $1m of relevant income/expenditure) or would not apply to smaller taxpayers (e.g. turnover under $80m). The fourth was supportive of a de minimis rule for the imported mismatch rule.

51. Other than where the rules apply to timing mismatches, officials do not support a de minimis at this stage, but this will be discussed further as part of the private sector workshops. The OECD Final Report does not have a de minimis. For many of the rules, e.g. recommendations 3 and 6, it would be very complex to have a de minimis based on transaction size which could not also be abused. The issue of size is partly resolved by observing that the rules only apply to taxpayers entering into more complex cross border transactions. Within that context, even smaller taxpayers can be expected to understand how they are taxed in the countries in which they operate, recognizing that in most cases the rules only operate within control groups or related parties.

52. In relation to the imported mismatch rule, presumably the de minimis would generally be based on the level of a New Zealand company's interest expense. This could be a workable rule, though if a group has operations in, for example, the UK, the group will have identified possible imported mismatches in any event.

53. Officials will keep this matter under review, with a particular eye to whatever measures are adopted in Australia.

Regulatory capital (banks and insurance companies)

54. A number of submissions addressed the question of whether regulatory capital required to be issued by banks and insurance companies should be subject to the hybrid regime. Capital adequacy regulations may lead, if not inevitably then without apparent effort, to the issue of cross border hybrid arrangements. A significant amount of hybrid capital has been issued by the New Zealand branches of the Australian trading banks with New Zealand operations. This capital is hybrid because it is treated as debt by New Zealand (and is therefore deductible) and as equity by Australia (and can therefore have franking credits attached to it, which can reduce or eliminate an Australian holder's Australian tax liability on the dividend).

55. Submissions made the following arguments:

- Deductible/frankable instruments should not be regarded as hybrids at all, because franking credits are a limited resource and represent tax actually paid in Australia.
- Bank regulatory capital should be excluded from the hybrid rules, given that the legal terms which give rise to its hybridity (subordination to other debt, conversion to equity in the case of distress etc.) are often the result of regulatory requirements.
- Bank regulatory capital should be excluded from the hybrid rules because it is economically important.
- Banks do not have a choice as to whether or not to attach franking credits to the return paid on deductible/frankable instruments – attachment of credits is a requirement of Australian law. Accordingly it would not be appropriate to apply the hybrid rules to the tax treatment of that return.
- Bank regulatory capital should be excluded from the hybrid rules because the effect of including it will be that it is replaced with debt having a higher rate of interest, which would reduce the New Zealand tax base. Currently the hybrid debt has a lower rate of interest, because the third party lenders (mostly Australian individuals and investment entities) are prepared to take a lower cash return given that they receive franking credits on top of the interest.
- Bank regulatory capital should be grandparented if issued before a certain date, especially because it is often publicly issued and refinancing it would not be straightforward.

56. With the exception of the sixth point, and possibly the fifth point, officials do not believe that these submissions have much force for the following reasons:

- In relation to deductible/frankable instruments, there is a hybrid mismatch. It is true that the nature of the imputation system means that this mismatch cannot be inexhaustibly tapped. However, so long as a company is not otherwise

distributing all of its tax-paid profits (which is relatively unusual), the mismatch can be profited from in a similar way as a deductible/non-assessable mismatch.

- As to the second and third submission, applying the hybrid rules to bank regulatory capital does not prevent such capital being issued cross border. It simply ensures that it does not enjoy an unintended tax benefit. The banking regulators have no interest in whether regulatory capital gives rise to tax benefits or not, and the removal of such benefits will in no way undermine their work. The result of applying the hybrid rules is simply that regulatory capital instruments are treated the same way as they would if both the issuer country and the investor country had the same tax rules.
- As to the fourth submission, the Australian requirement to attach franking credits to the distribution is entirely consistent with New Zealand denying a deduction for the distribution. The distribution will then be treated as a payment of a dividend by both Australia and New Zealand. There is more of a difficulty for Australia in determining how it should apply the hybrid rules. It might, for example, be difficult for Australia both to require a franking credit to be attached to the dividend, and deny the shareholder a credit for that imputation credit. However, this is an issue for Australia to determine.
- As to the fifth submission:
  - When the deductible/frankable instruments were first issued, to some extent they did replace equity, rather than debt, financing. It is possible that if they are cancelled, they will be partly replaced with equity.
  - The banks issuing these instruments are currently operating with more equity than "required" by the thin capitalisation rules, and accordingly the hypothesis that they will always minimise their New Zealand equity is not correct.
  - Because they bear a higher risk, deductible/frankable instruments have a higher funding cost than ordinary debt. This helps counter the rate reduction achieved by the tax arbitrage.
  - Not all deductible/frankable instruments are issued to third parties. There are also structures involving intra-group issuances which support third party issuances. The return payable on some instruments issued in these structures have been sufficiently high to raise transfer pricing concerns.

  However, in the event that Australia decides not to deal with the treatment of deductible/frankable regulatory capital, officials would wish to consider more closely the effect on the New Zealand tax base of applying the hybrid rules to it.

57. New Zealand's stance in this matter will not be relevant if Australia acts, in accordance with hybrids recommendation 2, to tax the return on deductible/frankable instruments as interest (and therefore not frankable). A decision on this has been expected for some time, but has not yet been made. Officials intend to meet with submitters on this point once the Australian decision on regulatory capital has been announced. Officials will also consult with the Reserve Bank of New Zealand before final policy recommendations are made.

58. Officials are sympathetic to the arguments in favour of grandparenting regulatory capital issued before the release of the Government discussion document on 6 September 2016. The finer details of grandparenting are likely to be clearer in our next report on this

matter. Officials also hope that any grandparenting will be co-ordinated and consistent with whatever decision is made by Australia.

Effect on New Zealand foreign trusts

59. The discussion document on hybrid mismatch arrangements proposes to apply the hybrid rules to tax the foreign source income of New Zealand foreign trusts (i.e. trusts with a New Zealand trustee but no New Zealand settlor) if that income is not being taxed to:

- the beneficiary, in the case of beneficiary income;
- the settlor, in the case of trustee income,

in the beneficiary/settlor's country of residence, if the non-taxation in the residence country is the result of the trust being a reverse hybrid. We received one submission in favour of this proposal and 7 not in favour.

60. Many of the submissions referred to the fact that the 2016 report of the Government Inquiry into Foreign Trust Disclosure Rules (the Shewan Report) recommended no change to the current trust tax regime. They argued that this recommendation supported not applying hybrids recommendation 5.2 to New Zealand foreign trusts. However:

- the terms of reference of the Inquiry were directed solely at trust record keeping and disclosure, not trust taxation;
- the comments which were made in the Shewan Report on trust taxation were not made having any regard to the double non-taxation issue which is central to the hybrid rules. The Shewan Report was considering the appropriateness of the trust tax regime as a matter of the coherence of the New Zealand tax base on a stand-alone basis. It correctly stated that the non-taxation of non-residents on non-New Zealand source income was and remains orthodox international tax policy (paragraph 4.15). Leaving aside the hybrid rules, the Report recognized that it is reasonable for New Zealand not to tax such income when it is derived by the New Zealand resident trustee of a trust with no New Zealand settlor. However, the Shewan Report did not consider the impact of BEPS Action 2 on international tax policy. In particular, it did not consider whether a New Zealand foreign trust is a reverse hybrid (as defined for purposes of the hybrid rules) and whether, if it is, New Zealand tax should be imposed on its income.

61. The Inquiry concluded that the changes to trust disclosure rules and practice which it recommended would deal adequately *with the problems identified, including reputational risk.* It was not asked to, nor did it, consider the problem of double non-taxation, and accordingly no conclusions were reached or recommendations made that are relevant to this issue.

62. Officials have discussed the preceding paragraphs with John Shewan, who agrees that we have accurately reflected the scope and conclusions of his report.

63. Submissions against our proposal raised a number of other points which, along with our responses, are summarised below.

- A New Zealand trust is not a reverse hybrid, since it is not tax transparent in New Zealand. That is because the trustee is always taxable on New Zealand source trustee income. This submission is not correct. An entity can be partially tax transparent. The Final Report states (paragraph 140) that a person will be treated as tax transparent in respect of a payment where the reverse hybrid attributes or allocates a payment that it has received to an investor, and the effect of such attribution or allocation is to treat the payment as it would have been treated had it been paid directly to the investor. Clearly then a New Zealand foreign trust is tax transparent with respect to income allocated to beneficiaries. As the Government's discussion document stated, this is not the case for trustee income. The argument for New Zealand taxation of foreign source income in that situation rests on the New Zealand principle that the residence of the settlor determines whether or not the trust's foreign source income is subject to New Zealand tax.
- The current tax treatment of New Zealand foreign trusts is appropriate and should be maintained. We agree that the current tax treatment makes sense on a single jurisdiction basis. However, it can lead to double non-taxation as a result of a hybrid mismatch. If the jurisdiction of the settlor (in the case of trustee income) or the beneficiaries (in the case of beneficiary income) would ordinarily tax the income, but is not doing so because it regards the income as derived by the New Zealand trustee, then there is double non-taxation as a result of differing treatments of the trust. This is an issue which the hybrid rules are trying to address.
- Determining whether a New Zealand foreign trust and the settlor are in the same "control group" is not possible. Some work may need to be done in this respect, but our current associated person rules will provide a good foundation.
- The fact that the foreign settlor of a trust is not taxed in another country on foreign source trustee income does not justify New Zealand taxing the New Zealand trustee on that income. The settlor is not taxed because the income is not theirs. Indeed, the settlor may be dead when the income is derived. This submission ignores the fact that the basis for New Zealand not taxing this income is the residence of the settlor. The logical extension of this approach is that the settlor's residence country should regard the income as that of the settlor.
- It might be more logical to tax the New Zealand trustee on its foreign source trustee income if it can be determined that the beneficiaries who will receive the income are not taxable on the income. However, in a discretionary trust this is not possible, because it is not known which beneficiary will receive the income. We do not agree that the foreign tax treatment of the settlor should not be taken into account. We do agree though that, if it can be shown that a beneficiary is subject to tax on foreign source trustee income, that would mean there is no hybrid mismatch to counteract in New Zealand.
- Non-taxation of the settlor or a beneficiary might be a result of the person being resident in a country with no income tax, or with a territorial tax system, rather than because the person is resident in a jurisdiction which treats the income as derived by the trustee. We agree that in this case, double non-taxation is not a result of a hybrid mismatch, and there should be no hybrid counteraction.

Applying the rules only to cases where mismatches result from hybridity will be required generally, and this is not a special case.

- Difficulties would arise from the proposal where the trust holds foreign shares which are taxed under the fair divided rate (FDR) method. The FDR method is unique to New Zealand. Since the settlor residence country will not be taxing on the same basis, the reason that the trust's income (calculated under New Zealand law) is not taxable in the settlor country is that that country will not see the settlor as having such income. We agree that differences of this kind will create complexity. However, this complexity will be an issue for other aspects of the rules as well, and will need to be dealt with. As a matter of principle, the issue would be resolved by determining, in the year the New Zealand income is derived whether the beneficiary or trustee would be taxed on that income if it also arose in their residence jurisdiction.
- Compliance costs from this proposal would be substantial and in most cases no tax would be generated. There would no doubt be some compliance costs from this proposal, though in the main they would revolve around the need to communicate information already known by one of the parties or its advisors to the other parties or advisors. An assumption that this sort of "intra-group" communication is possible underpins many of the proposed rules and we do not consider there are any good reasons for treating trusts differently. It is possible that no or little New Zealand tax would be generated. However, the proposals would assist in the general move towards shutting down hybrid-mismatch-driven double non-taxation, the aim of which is to increase global tax revenues.
- The proposal goes well beyond the ambit of the hybrid proposal, and appears to be advanced to support New Zealand tax applying when none would ever arise apart from the existence of a New Zealand resident trustee. This submission misses the point that the effect of the rules will only be to rectify double non-taxation arising from the existence of the New Zealand resident trustee. For example, if the settlor would not be taxed on the foreign source income if it derived the income directly, there is no suggestion that the hybrid rules would impose New Zealand taxation on that income if derived by a New Zealand tax resident trustee on whom the settlor has settled the income producing property.

64. Since New Zealand trusts can give rise to double taxation due to hybrid mismatches, we intend to continue to develop our proposals in this respect, though we agree that applying New Zealand tax to trustee income on the basis of the existence of a hybrid mismatch will present some challenges.

Interaction with withholding tax

65. A number of submissions were concerned by the proposal in the Discussion Document that where an interest payment is disallowed under the hybrid rules, withholding tax would still be imposed as if that payment were interest. They were concerned that this would constitute double taxation. If the payment were treated as a dividend and fully imputed, it would not be subject to withholding tax.

66. This is a complex issue. It may well be the case, at least with respect to recommendations 1 and 3, that ideally, the withholding tax treatment would match the deductibility status. However, we have assumed that this might not always be possible, particularly if the payer is not aware at the time of making the payment that the hybrid rules deny a deduction. Officials are continuing to review this question.

Transitional

67. The OECD Final Report recommended no grandparenting of existing transactions and an effective date based on the tax year which gives taxpayers sufficient time to restructure their transactions, which will all be either between related parties or within a control group.

68. The Discussion Document proposed to follow this approach, with the effective date being the first balance date after enactment of the legislation.

69. A number of submissions were in favour of grandparenting existing transactions, either without limit, or for 3-5 years. This was on the basis that taxpayers should be entitled to retain tax benefits that existed when transactions were entered into.

70. As set out in paragraph 58, we now propose to consider limited grandparenting for frankable/deductible instruments issued before the release of the Discussion Document. Consistent with the OECD, and the approach in the UK, we do not propose any further grandparenting. The hybrid rules are doing no more than removing tax benefits which were not, in aggregate, intended by either country, and restoring a more "normal" result. The hybrid rules apply generally to transactions between related parties, which can generally be undone with relative ease. If there are any situations where this is not so, as with the frankable/deductibles, they have not emerged in consultation to date. If any emerge, we can consider them on a case by case basis.

71. Many submitters supported New Zealand having the same effective date for the rules as Australia. Others submitted that New Zealand should not enact its rules until after the Australian rules have become effective, in order to give more clarity.

72. Officials are sympathetic to the submissions for co-ordination on this point with Australia, but continue to believe at this stage that the core proposal (effective for balance dates after enactment) is a reasonable one.

Consultation process

73. A number of submissions sought further consultation on the proposals. Officials are sympathetic to these submissions, and are currently engaged in a consultation programme that is scheduled to take place between now and June. As mentioned above, we anticipate this process will also include consultation on the OECD's discussion draft on branch mismatches.

This timeline could be altered to allow for final Cabinet decisions to be made before the pre-election period commences on 23 June. However, this would inevitably reduce the scope and/or depth of the consultation. The private sector may also be disappointed by such a change. We welcome your views on the timing of this process.

74. Some submitters also sought the opportunity to review draft legislation. Draft legislation was released for comment in the UK, and Australia is likely to do the same. Officials currently consider that, if final policy decisions are made before the election (irrespective of whether this is just before or after the pre-election period commences), consulting on draft legislation over the election period would be a useful exercise. Given the inevitable complexity of legislation on these issues, consultation on draft legislation would likely result in a smoother select committee process when final legislation is introduced to Parliament. If you indicate you are comfortable with consultation on draft legislation, we will include a request to that effect in the Cabinet paper seeking final policy decisions.

Appendix 1: List of submitters to Government discussion document Addressing Hybrid Mismatch Arrangements

Andrea Black
ANZ Bank New Zealand Limited
ASB Bank Limited
Bank of New Zealand
Baucher Consulting Limited
Chapman Tripp
Chartered Accountants Australia and New Zealand (CA ANZ)
Corporate Taxpayers Group (CTG)
Deloitte
Ernst & Young Limited
Fisher & Paykel Healthcare Limited
Insurance Australia Group Limited (IAG)
JJL Hoogenboom
KPMG
New Zealand Bankers' Association (NZBA)
New Zealand Law Society
Olivershaw Limited
PricewaterhouseCoopers
Russell McVeagh
Westpac New Zealand Limited

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Cabinet paper - foreign hybrid entity double deductions and BEPS reforms

Date:	6 April 2017	**Priority:**	**High**
Security level:	Sensitive - Budget	**Report no:**	T2017/949 IR2017/237

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations of this report. **Authorise** the lodgement of the attached Cabinet paper.	Either: • 10:00 am Wednesday 12 April 2017 for Cabinet on 18 April 2017; or • As soon as possible as a late paper for EGI on 12 April 2017.
Minister of Revenue	**Agree** to the recommendations of this report. **Authorise** the lodgement of the attached Cabinet paper.	Either: • 10:00 am Wednesday 12 April 2017 for Cabinet on 18 April 2017; or • As soon as possible as a late paper for EGI on 12 April 2017.

Contact for telephone discussion (if required)

Name	Position	Telephone
Steve Mack	Principal Advisor, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Paul Kilford	Policy Manager, Inland Revenue	[redacted]

6 April 2017

Minister of Finance
Minister of Revenue

Cabinet paper - foreign hybrid entity double deductions and BEPS reforms

1. This report asks you to refer the attached Cabinet paper to Cabinet Office so that it may be considered either by:
   - The Economic Growth and Infrastructure Committee (EGI) at its meeting on 12 April 2017; or
   - Cabinet at its meeting on 18 April 2017.

2. The paper proposes that Cabinet:
   - Agree to tax law changes to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships, to reduce their tax liabilities in New Zealand; and
   - Note the progression of proposals contained in three BEPS discussion documents (*Addressing hybrid mismatch arrangements*, *BEPS – transfer pricing and permanent establishment avoidance,* and *BEPS - strengthening our interest limitation rules*), subject to modification in consultation.

3. If Cabinet agrees to these recommendations, the Budget 2017 revenue forecasts will be adjusted by $100 million per year from 2019/20 (with $50 million forecast in the preceding year).

Recommended action

We recommend that you:

Authorise lodgement of the attached Cabinet paper either:

a. by 10:00 am, Wednesday 12 April 2017 for Cabinet on 18 April 2017.

Authorised/Not authorised

Authorised/Not authorised

OR

b. as soon as possible as a late paper for EGI on 12 April 2017.

Authorised/Not authorised

Authorised/Not authorised

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

Steve Mack
Principal Advisor
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Budget Sensitive

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

FOREIGN HYBRID ENTITY DOUBLE DEDUCTIONS AND BEPS REFORMS

Proposal

1. This paper seeks Cabinet agreement to tax law changes to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships, to reduce their tax liabilities in New Zealand. In addition, this paper seeks Cabinet's approval for the proposals of three BEPS discussion documents to be progressed, subject to modification in consultation.

Executive summary

2. In September 2016, the Government released the discussion document *Addressing hybrid mismatch arrangements* [CAB-16-Min-0442]. This was followed by the release of two further discussion documents for public consultation in March 2017; *BEPS – transfer pricing and permanent establishment avoidance*, and *BEPS - strengthening our interest limitation rules* [CAB-17-MIN-0041]. These three documents are a substantial part of the Government's ongoing response to the OECD's project to address base erosion and profit shifting (BEPS). BEPS is a term that describes the various international tax planning techniques that some multinational businesses use to minimise their tax liabilities.

3. The *Addressing hybrid mismatch arrangements* discussion document proposed a comprehensive response to hybrid mismatches, including the use of double deductions by hybrid entities. Officials are currently consulting with the private sector on specific design issues relating to the proposals in the discussion document.

4. Before then, it is important to confirm that the Government is willing to act on the most prevalent hybrid structure involving outbound investment by New Zealand-based groups by restricting the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships (ALPs), to reduce their tax liabilities in New Zealand.

5. This paper also seeks Cabinet's approval for the other BEPS reforms proposed in the September 2016 and March 2017 discussion documents to be progressed, subject to modification in consultation, for implementation from 1 July 2018. When combined with the decision on foreign hybrid entity double deductions, this will result in an adjustment to the revenue forecasts of $100 million per year from 2019/20 (with $50 million forecast in the preceding year). Given this is a conservative estimate, we note there is an accompanying positive fiscal risk that the revenue may be higher than estimated.

6. We currently anticipate that final policy recommendations on these BEPS reforms will be considered by Cabinet later this year.

Background

BEPS

7. The New Zealand Government's ongoing BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan, which was finalised in October 2015. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

8. Part of the OECD/G20 BEPS Action Plan is *Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements* (the OECD recommendations), under which the OECD has designed a set of hybrid mismatch rules for countries to incorporate into their own tax systems. While it is not mandatory to adopt the OECD recommendations, OECD and G20 countries have agreed a general tax policy direction in respect of Action 2. This means that they are expected to converge over time in their treatment of hybrid mismatch arrangements following the agreed common approaches.

9. The OECD has also recommended actions on *limiting base erosion involving interest deductions and other financial payments* (Action 4), *preventing the artificial avoidance of permanent establishment status* (Action 7) and *aligning transfer pricing outcomes with value creation* (Actions 8-10). The Government's March 2017 discussion documents outline a package of proposed law changes intended to address the OECD's concerns and recommendations in these areas, although the specific proposals are tailored for the New Zealand environment and so differ in some respects from the OECD's recommendations.

Hybrid mismatch arrangements

10. Hybrid mismatch arrangements arise when countries classify transactions and entities differently from each other under their domestic laws. For example, fixed rate shares may be treated as debt in one country and shares in another. This is inevitable. However, differences in classification provide multinational groups with opportunities to arbitrage between tax systems in two or more jurisdictions to create tax advantages. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

11. The Government's discussion document *Addressing Hybrid Mismatch Arrangements* proposed that New Zealand adopt the OECD recommendations by enacting a specific set of rules that remove the tax advantages of hybrid mismatch arrangements. The proposals apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of having hybrid mismatch rules is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

12. The global response on adopting the OECD recommendations on hybrid mismatch arrangements is as follows:

a. The United Kingdom enacted rules earlier this year to counter hybrid mismatch arrangements (effective 1 January 2017).

b. The EU has released a binding directive which requires EU members to introduce hybrid rules (effective 1 January 2020).

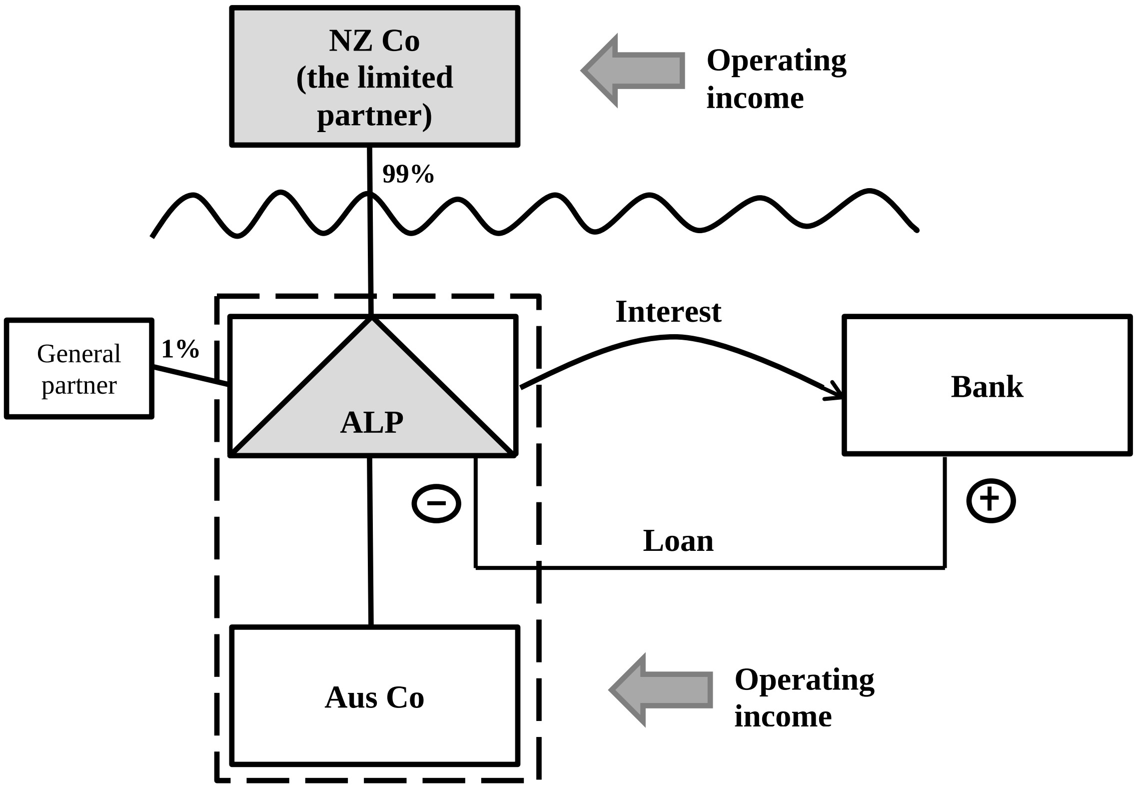
c. Australia is committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment).

Foreign hybrid entity double deductions

13. A type of hybrid mismatch featured in the OECD recommendations and featured in the *Addressing hybrid mismatch arrangements* discussion document is the double deduction mismatch, whereby a multinational group claims a tax deduction in two different jurisdictions for what is in substance one item of expenditure. This is most commonly achieved through the use of a hybrid entity – an entity that is treated for tax purposes as transparent (its income and expenditure is attributed to its owners) in the jurisdiction of its parent and opaque (it is taxed as a separate entity on its income and expenditure) in the jurisdiction it was established in. If that hybrid entity makes a loss it can be grouped against the profits of a related party in its establishment jurisdiction. Additionally, the hybrid entity's parent is attributed the losses of the hybrid entity under the parent jurisdiction's laws which can then be offset against its own profits. Each of these entity characterisations is valid when viewed in isolation, but in combination the hybrid entity allows the group to reduce its taxable income in two countries where there is only one economic loss.

14. This double deduction effect can be achieved through the use of an Australian Limited Partnership (ALP), which is a type of hybrid entity that can be established in Australia with a New Zealand company as the 99% parent/limited partner. The diagram below sets out this structure and assumes that the ALP borrows money from a third party bank (and pays interest on that loan) to help fund the wider group.

Figure 1 – ALP double deductions structure



15. The ALP is treated akin to a company in Australia, such that its deductions resulting from its interest payments can be grouped with the operating income of Aus Co to reduce tax payable in Australia. However, the ALP is treated as a partnership in New Zealand, so (99%

of) its deductions are attributed to NZ Co (the limited partner) and can be offset against New Zealand operating income. In this example, the expenditure of the ALP, and its ability to claim deductions, is uncontentious – it is interest payable at an arm's length rate to a bank. Nevertheless, the tax revenue collected on two sources of operating income in two countries is reduced by using the ALP as the paying entity.

16. This paper seeks Cabinet agreement to introduce tax law changes to restrict the ability of a New Zealand business to use double deductions of foreign hybrid entities, such as ALPs, to reduce its New Zealand tax liability. This restriction may be limited, so it applies only to the extent that the double deductions are used to reduce the foreign tax liability of a related party.

17. Alongside rules to achieve this effect, an option being considered to reduce compliance costs is to develop an elective regime whereby the New Zealand parent of a foreign hybrid entity could elect to treat that entity as opaque in order to match the foreign jurisdiction treatment. This may achieve a slightly harsher outcome to the hybrid rule proposal, with reduced compliance costs. The purpose of such a rule would be to allow taxpayers a path to removing the tax advantage of their foreign hybrid entities while avoiding the scope of the proposed hybrid mismatch rules which carry a higher degree of complexity.

18. Final policy and design proposals on how the rule countering double deductions would be given effect, along with the remaining parts of the hybrid mismatch arrangements project, will be considered by Cabinet later this year. We currently anticipate this paper will be contemporaneous with a paper detailing the response to the other BEPS proposals mentioned below.

Other BEPS initiatives

19. The *BEPS – transfer pricing and permanent establishment avoidance* discussion document consults on proposals to counter permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue deal with uncooperative multinationals. These proposals are aimed at large multinationals that are able to report low taxable profits in New Zealand despite significant economic activity here. The main proposals are:

- An anti-avoidance rule that will prevent multinationals from structuring their operations to avoid having a permanent establishment (a taxable presence) in New Zealand where one exists in substance.

- Stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income.

- Stronger transfer pricing rules which will adjust related party transactions if they don't align with the actual substance of the multinational's economic activities and shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arms-length.

- A range of administrative measures that will strengthen Inland Revenue's powers to deal with large multinationals (with at least EUR €750m of global revenues) that do not co-operate with a tax investigation.

20. Many of these proposals are based on similar tax reforms that Australia has introduced in recent years.

21. The *BEPS – strengthening our interest limitation rules* discussion document consults on proposed law changes that will limit the ability of multinationals to use interest payments to shift their New Zealand profits offshore. The main proposals are:

- A proposal to limit high-priced related party debt by introducing an interest rate cap. The proposed cap would base the allowable interest rate on the market interest rates that the particular multinational group would actually use when borrowing from a third party such as a bank. The cap would be based on the credit rating of the multinational group as a whole, rather than their New Zealand subsidiary.

- A proposal to tighten our existing thin capitalisation rules which limit debt as a percentage of total assets. The proposed rule would remove assets funded by non-debt liabilities from the measure of a firm's total assets. Examples of non-debt liabilities are trade credits, provisions and out-of-the-money derivatives. This change would bring New Zealand's rules more in line with other countries with thin capitalisation rules, including Australia.

Consultation

22. Inland Revenue and Treasury officials have discussed the foreign hybrid entity double deductions issue with interested private sector groups as part of ongoing consultation workshops on the wider hybrids project. Officials have also been in contact with the Australian Tax Office, the Australian Treasury, and the OECD secretariat in relation to this particular issue and the wider project.

23. In relation to the two March discussions documents, Inland Revenue has also consulted with the Treasury, the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment. Officials have also been in contact the Australian Treasury and the Australian Taxation Office. Officials have started to meet with key stakeholders to discuss these proposals but submissions are not due until 18 April.

Financial implications

24. The proposed rule on foreign hybrid entity losses derived from the *Addressing hybrid mismatch arrangements discussion document* is estimated to increase tax revenue by $50 million per annum once fully implemented. In the first year of application 2018/19, approximately half ($25 million) of that estimated revenue will be captured.

25. That rule may influence taxpayers to restructure their arrangements so that they fall out of the scope of the rule. This should not alter the estimated revenue effect. Further, specific design issues relating to the proposed rule (such as the opaque election to ease compliance costs) should not affect the estimated revenue.

26. A total of $140 million in additional BEPS revenues was estimated at the time the March discussion documents were released - assuming all of the proposals are implemented.

27. We seek Cabinet's approval for the BEPS reforms to be progressed, subject to modification in consultation, for implementation from 1 July 2018. When combined with the decision on foreign hybrid entity double deductions, this will result in an adjustment to the revenue forecasts of $100 million per year from 2019/20 (with $50 million forecast in the preceding year). Given this is a conservative estimate, we note there is an accompanying positive fiscal risk that the revenue may be higher than estimated.

28. These estimates assume that the Government will introduce a BEPS taxation bill following the general election which includes the proposed foreign hybrid entity rule and other proposed BEPS measures and that the bill is enacted as legislation and is in force by 1 July 2018.

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

Human rights

29. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative implications

30. Primary legislation would be required to implement the proposals in this paper. At this stage, it is feasible for legislation to be introduced to Parliament that will encompass all the BEPS measures (including the hybrids mismatch arrangements project) in an omnibus taxation bill following the September general election.

Regulatory impact analysis

31. The Regulatory Impact Analysis Team at Treasury has advised that Inland Revenue is not required to prepare a Regulatory Impact Statement (RIS) at this stage of the policy process. The merits of the "in principle" decisions being taken at this stage can be made based on analysis already provided in the public consultation papers released last year (on hybrids) and in March (for the balance of the BEPS proposals). A RIS will be provided when Cabinet is asked to make final policy decisions on these measures.

Publicity

32. The offices of the Minister of Finance and the Minister of Revenue will arrange for the announcement of this decision if necessary, whether as part of Budget 2017 or otherwise.

Risks

33. There are risks associated with including the revenue from these changes in the Budget documents. Particularly in respect of the issues covered by the March discussion documents, the Government could be accused of making decisions before the consultation period has closed, effectively circumventing the generic tax policy process. Equally, the private sector may see the relatively conservative estimate of $50m for these changes as an indication that the Government does not intend to implement the full suite of changes being consulted on.

34. In any event, we consider risks can be mitigated through clear communication of the process by which the estimates are included in the Budget process.

Recommendations

35. We recommend that you:

1. **Agree** to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships (ALPs), to reduce their tax liabilities in New Zealand;

2. **Note** that the reforms proposed in the three BEPS discussion documents *Addressing Hybrid Mismatch Arrangements, BEPS – transfer pricing and permanent establishment avoidance* and *BEPS – strengthening our interest limitation rules* will be progressed, subject to modification in consultation, for implementation from 1 July 2018;

3. **Note** that as a result of agreeing to the foreign hybrid entity double deductions measure and progressing the hybrid mismatch arrangements project and the other BEPS proposals, the Budget 2017 revenue forecasts will adjusted as follows:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

4. **Note** that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later this year.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: New Zealand's adoption of the OECD's Multilateral Instrument

Date:	18 April 2017	**Priority:**	**High**
Security level:	Restricted	**Report no:**	T2017/1004 IR2017/260

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations of this report **Sign** the attached Cabinet paper	26 April 2017
Minister of Revenue	**Agree** to the recommendations of this report **Refer** the attached papers to the Minister of Foreign Affairs for consultation **Sign** and **refer** the attached Cabinet paper and accompanying documents to Cabinet Office	10am, 27 April 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Carmel Peters	Policy Manager, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Jess Rowe	Senior Policy Advisor, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	

18 April 2017

Minister of Finance
Minister of Revenue

New Zealand's adoption of the OECD's Multilateral Instrument

Executive summary

1. New Zealand's adoption of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("the Multilateral Instrument" or "MLI") is one of the core parts of the Government's base erosion and profit shifting (BEPS) reform package.

2. The MLI will modify a significant number of New Zealand's existing double tax agreements (DTAs) in order to bring them into line with OECD recommendations to address BEPS. The New Zealand Government has committed to signing the MLI on 7 June 2017 at the OECD signing ceremony in Paris.

3. This report recommends that you sign and submit the attached Cabinet paper to the Cabinet Office by 10am, Thursday 27 April 2017 for consideration by the Cabinet External Relations and Defence Committee at its meeting of 2 May 2017.

4. The Cabinet paper seeks authority for New Zealand to sign the MLI. The Cabinet paper also seeks approval for the steps necessary to give effect to the provisions of the MLI under New Zealand law. As one of the steps involves Parliamentary treaty examination, the Cabinet paper seeks approval of an extended National Interest Analysis ("NIA").

5. The Ministry of Foreign Affairs and Trade has been consulted during the preparation of the attached Cabinet paper and NIA.

6. An officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. The issues paper sought feedback on possible implementation issues associated with New Zealand's signature and ratification of the MLI. Submissions closed on 7 April 2017 and five were received. Two stakeholder workshops (with representatives from Chartered Accountants Australia and New Zealand (CA ANZ) and Corporate Taxpayers Group (CTG)) were held on 27 and 28 March 2017 to enable officials to better understand practitioners' concerns.

7. This report provides you with an overview of the submissions received and alerts you to aspects of the MLI considered to be the most controversial by submitters.

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[redacted]

Recommended action

We recommend that you:

(a) **Note** that five submissions were received on the MLI issues paper and this report summarises the submissions received and officials' advice with respect to those submissions.

Noted | Noted

(b) **Refer** this report and its attachments to the Minister of Foreign Affairs for consultation.

Referred/Not referred

(c) **Agree** to the recommended position for New Zealand on each substantive provision of the MLI set out in Appendix B.

Agreed/Not Agreed | Agreed/Not Agreed

(d) **Sign and refer** the Cabinet paper, the text of the MLI, New Zealand's draft reservations and notifications, and the extended NIA to Cabinet Office before 10am on Thursday 27 April 2017.

Signed/Not signed | Signed and referred/Not signed and Referred

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

1. Addressing tax treaty abuse has been a major part of the BEPS project and a number of the Action items in the OECD/G20 BEPS Action Plan make recommendations that can only be implemented through changes to DTAs, including:

- preventing the granting of treaty benefits in inappropriate circumstances;
- preventing the artificial avoidance of permanent establishment status;
- neutralising the effects of hybrid mismatch arrangements that have a treaty aspect and modifying the approach to a company that is resident in both contracting states; and
- providing improved mechanisms for effective dispute resolution.

2. Some of these recommendations are BEPS "minimum standards" that countries that commit to solving BEPS are expected to adopt. All other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following adoption of the OECD/G20 BEPS Action Plan.

3. Countries were presented with the difficulty of how to quickly and efficiently implement these measures without requiring the bilateral renegotiation of several thousand existing DTAs. To this end, the OECD brought approximately 100 jurisdictions together to develop a multilateral treaty that would swiftly modify the DTAs of participating jurisdictions, thus avoiding the need for protracted bilateral negotiations.

4. New Zealand officials were involved in the negotiation of the MLI text, which was formally adopted by the OECD in November 2016.

5. The New Zealand Government has committed to signing the MLI on 7 June 2017 at the OECD signing ceremony in Paris and the Minister of Finance has delegated this duty to the Minister of Revenue. An Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI. The Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature.

6. New Zealand and other participating jurisdictions have submitted a preliminary list of notifications and reservations to the OECD, which includes the DTAs New Zealand has nominated to be modified by the MLI. These lists will determine which of New Zealand's DTAs are modified and how they are modified, but will not be considered final until New Zealand ratifies the MLI.

7. Where both parties to a DTA include that DTA in their respective lists of notifications and reservations, that DTA is a "covered tax agreement". A list of New Zealand's current covered tax agreements based on preliminary notifications and reservations as at 11 April 2017 is included at Appendix C. Based on current draft notifications, New Zealand is expected to have 29 covered tax agreements. While this list is not final, it provides a fairly

good indication of the likely coverage of the MLI. New Zealand's approach is to nominate most of its 40 DTAs. This gives New Zealand the best chance of strengthening our DTAs with as many jurisdictions as possible. The only DTAs not nominated are those with counterparties who are not expected to sign the MLI.

8. A list of the provisions New Zealand has indicated it will adopt is included as Appendix B. New Zealand's approach has been to adopt all applicable minimum standard and optional provisions. This is because the OECD Model Tax Convention plays an important role in informing New Zealand's treaty policy and New Zealand has committed to resolving BEPS more generally. New Zealand also believes the changes to be made by the MLI are correct in principle and should be as widely adopted as possible.

Public consultation

9. An officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. The issues paper sought feedback on possible implementation issues associated with New Zealand's signature and ratification of the MLI.

10. While we do not generally consult on tax treaties, because of the novel nature of the MLI we recommended seeking submissions from the private sector on how it will work in practice. This issues paper focused on implementation issues, however submitters also commented on the substantive provisions as well.

11. Submissions closed on 7 April 2017 and five were received from Chartered Accountants Australia and New Zealand (CA ANZ), Corporate Taxpayers Group (CTG), EY, PwC and KPMG.

12. Two stakeholder workshops with representatives from CA ANZ and CTG were held on 27 and 28 March 2017 to enable officials to better understand practitioners' concerns prior to formal submissions being made.

Overall comments

13. CA ANZ and EY supported the adoption of the MLI as the most effective way to implement the treaty-related BEPS recommendations. EY agreed that the MLI should be implemented as widely as possible, taking up minimum standards and virtually all optional articles, with few reservations.

14. PwC acknowledged that participating in OECD and G20 initiatives to target BEPS is a key focus for the New Zealand Government, while not explicitly supporting the adoption.

15. CTG did not express an overall view on adoption, but submitted that New Zealand should not adopt all of the optional provisions.

16. KPMG acknowledged that the New Zealand Government has the constitutional ability to decide New Zealand's tax treaty position and that it therefore makes sense to achieve this in the shortest time at the least cost through the MLI, but KPMG noted that despite this constitutional position, it is also clear that in the current environment there is a demand for transparency and actual consultation for New Zealand's treaties. KPMG submit that this has not occurred with New Zealand's decision to sign the MLI, even with the release of the issues paper and views the implementation of the MLI as a "fait accompli". KPMG references in their submission as a point of comparison, the detailed consultation undertaken by the Australian Government.

17. Officials note that, consistent with international treaty practice, the negotiation of the MLI was on a strictly confidential basis and that public consultation by Australia and the UK (like New Zealand), was undertaken after the MLI had been negotiated and formally adopted. Unlike New Zealand, however, Australia consulted on what position the Australian Government should take in relation to specific provisions. The New Zealand Government did not choose to take that approach – instead focussing on implementation.

Specific submissions

18. The main issues raised in submissions relate to:

- substantive positions taken by New Zealand;
- requests for additional guidance and administrative resources to help taxpayers apply DTAs as modified by the MLI; and
- technical domestic law changes.

Substantive positions taken by New Zealand

19. Consistent with New Zealand's approach to DTAs more generally, submissions were not requested on New Zealand's position on the substantive provisions of the MLI.

20. We note the MLI has been negotiated and adopted at an international level, and is not able to be changed. The text was formally adopted by the OECD in November 2016. New Zealand supported the outcomes of the OECD/G20 BEPS Action Plan which are reflected in the MLI. The strengthened provisions contained in the MLI will be incorporated into the OECD Model Tax Convention and New Zealand's negotiating model going forward.

21. The issues paper did include a summary of the provisions New Zealand is intending to sign up to, in order to provide additional context for submitters. Submitters did comment on New Zealand position on the substantive provisions. We have highlighted the most controversial aspects in Appendix D. Generally speaking, the issues raised in relation to the substantive provisions are able to be managed administratively, are necessary to ensure New Zealand's DTA network is strengthened against common BEPS techniques or are consistent with New Zealand's overall position as a supporter of the OECD/G20 BEPS Action Plan. The

positions are also broadly consistent with the direction of New Zealand's treaty policy over time.

22. The substantive points raised by submitters and officials' responses are summarised in the table in Appendix D.

Additional guidance and administrative resources

23. A strong theme in submissions was the need for administrative guidance and access to competent authority resource to resolve uncertainty associated with the implementation of the MLI.

24. Submitters requested:

- guidance on how Article 3 (the fiscally transparent entity provision) affects collective investment vehicles with non-resident beneficiaries;
- specific guidance on the competent authority process for the application of dual resident entity provision (Article 4) and in the case of Australia (at least) the existence of a streamlined process or a self-assessment system;
- guidance on the application of the 365 day rule in the dividend transfer provision (Article 8) where the 365 day rule has not yet been met;
- administrative guidance on a simplified measurement rule for assessing whether a company is a land rich company rule (Article 9), for example a rule based on quarterly measurements;
- guidance on the interaction between section BG 1 and the treaty principal purpose test (PPT) (for example, a standard practice statement);
- guidance on New Zealand's position on profit attribution to permanent establishments;
- that Inland Revenue should maintain a list on its website of covered tax agreements, dates of "entry into effect for specific taxes" for each of New Zealand's covered tax agreements and any changes/additions by DTA partners so that taxpayers can easily determine when a DTA has been modified and the effective date of amendments to particular provisions;
- that Inland Revenue should produce consolidated versions of New Zealand's DTAs as modified by the MLI; and
- more competent authority resource to address cases of double taxation and assist taxpayers with disputes.

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26. In relation to the request for specific guidance on the interaction between section BG 1 and the PPT, officials note that the Commissioner of Inland Revenue has previously issued a

substantial Interpretation Statement on the interpretation and application of the GAAR (IS 13/01 "Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007"). It is not considered that further guidance on how the PPT and the GAAR will apply would be helpful, and specific cases will depend on particular facts and circumstances. We also note that the OECD/G20 final report on Action 6 gave guidance on the interaction of domestic law general anti-avoidance rules and tax treaties, including the PPT.

27. In terms of providing guidance on New Zealand's approach to profit attribution to permanent establishments, this topic is not directly covered by the MLI and is still subject to work at the OECD level. Once that work is complete, consideration could be given to producing guidance on New Zealand's position on this issue.

28. In response to the request for Inland Revenue to produce consolidated versions of the DTAs modified by the MLI, we note that publishers may produce consolidated texts as they currently do with amending protocols and original DTAs. However, based on requests for Inland Revenue to produce these and the fact that many of our counterparties are already considering producing them, we are looking into whether it would be feasible for Inland Revenue to produce informal consolidated versions (or endorse those produced by our treaty partners), in respect of New Zealand's most significant DTAs. These informal versions would not be legally binding.

29. In addition to this, New Zealand Inland Revenue officials are continuing discussions with overseas counterparts to determine what additional certainty the competent authorities may be able to provide to taxpayers (for example, through a memorandum of understanding which sets out in further detail how each MLI provision applies to the DTA).

Technical domestic law changes

30. Submitters suggested a number of technical changes to domestic law.

31. In particular, they were concerned about ensuring that the arbitration process under the MLI would function seamlessly with New Zealand's domestic dispute resolution procedures. Officials will report separately to you on domestic law changes needed in this respect.

32. Submitters also suggested that domestic time limits for refunds should be extended (from the current 4 years) where a refund is the result of MAP or arbitration, given the length of time these processes can take.

33. Submitters also raised the need for clarity around the interaction between the strengthened permanent establishment provisions in the MLI and the proposed permanent establishment anti-avoidance provision currently being considered by the Government. Officials will advise Ministers on this issue when reporting on the outcomes of consultation on the Government Discussion Document *BEPS – Transfer pricing and permanent establishment avoidance*.

34. One submitter suggested there should be a domestic law change to prevent section BG 1 of the Income Tax Act 2007 applying in cases where the PPT in a DTA has been invoked.

Officials do not support this suggestion. It runs counter to the recent reform to ensure section BG 1 overrides DTAs in avoidance cases. The application of either or both provisions to a particular transaction will depend on the facts and circumstances of the case.

35. Officials will report to you separately with recommendations on these domestic law issues.

Next steps

36. This report recommends that you sign and refer the attached Cabinet paper to Cabinet Office. It is intended that the Cabinet paper be considered by the Cabinet External Relations and Defence Committee at its meeting of 2 May 2017. The Cabinet Office deadline for receiving papers for that meeting is 10am, Thursday 27 April 2017.

37. The Cabinet paper seeks agreement for New Zealand to sign the MLI. The Cabinet paper also seeks approval for the steps necessary to give effect to the provisions of the MLI under New Zealand law. As one of the steps involves Parliamentary treaty examination, the Cabinet paper seeks approval of an extended NIA.

38. After the MLI is signed, it will need to be given effect under New Zealand domestic law. This will be achieved by an Order in Council made under section BH 1 of the Income Tax Act 2007. We will report to you on the Order in Council once the MLI has been signed and other relevant steps have been taken, including the completion of Parliamentary treaty examination.

39. The Cabinet Manual requires that Cabinet approval for any treaty action be sought either jointly or in consultation with the Minister of Foreign Affairs. The Cabinet paper and accompanying documents therefore need to be referred to the Minister of Foreign Affairs for consultation.

40. The Cabinet paper and extended NIA, along with the full text of the MLI and New Zealand's proposed reservations and notifications are attached. The accompanying documents are to be appended as annexes to the Cabinet paper when it is submitted to Cabinet Office.

41. The reasons for signing the MLI are set out in the Cabinet paper and extended NIA, along with an analysis of the advantages and disadvantages of the MLI for New Zealand.

42. The Cabinet paper recommends, in particular, that Cabinet:

- approve the text of the MLI and New Zealand's reservations and notifications, and authorise the signing of the MLI;
- approve the extended NIA;

- agree that, following signature, the MLI and NIA be submitted for Parliamentary treaty examination;

- invite the Minister of Revenue to issue drafting instructions for an Order in Council to give effect to the MLI; and

- authorise officials (once all necessary steps have been completed) to deposit New Zealand's instrument of ratification with the MLI Depositary and confirm New Zealand's notifications and reservations.

43. There is an opportunity for the Minister of Revenue to sign the MLI at a signing ceremony arranged by the OECD, to be held in Paris on 7 June 2017. If the Minister of Revenue is not able to attend, then it is possible that another Minister or the New Zealand Ambassador to the OECD may be able to attend the signing ceremony.

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Appendix B

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
1. Neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2 report)	**Fiscally transparent entities** The MLI introduces or amends a fiscally transparent entity (FTE) provision. FTEs (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The MLI provision clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident. New Zealand already includes this provision (or an equivalent provision) in its DTAs with Australia, United States, Chile and Japan. *Article 3 of the MLI*	No	Yes	Similar substantive position to NZ. Adopt for DTAs that do not contain a detailed provision addressing FTEs.
	Dual resident entities The MLI introduces or amends a dual resident entity (DRE) tie breaker provision. Like FTEs, DREs can be used to take advantage of arbitrage opportunities. The proposed provision will require CAs to agree the residence status of a DRE. Where there is no agreement, either treaty benefits will be denied or only allowed to the extent the CAs agree. *Article 4 of the MLI*	No	Yes	Similar substantive position to NZ. Adopt, but exclude the last sentence (for constitutional issues).
	Relief of double taxation The MLI allows countries to strengthen their application of the exemption method to relieve double taxation. New Zealand already applies the (more robust) credit method in all of its DTAs, and therefore proposes not to adopt any of the options. *Article 5 of the MLI*	No	Not applicable	Same as NZ Not applicable

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
2. Preventing the granting of treaty benefits in inappropriate circumstances (Action 6 report)	**Preamble language – minimum standard** The MLI will amend the preamble to DTAs to emphasise that as well as aiming to relieve double taxation, the treaty also aims to prevent opportunities for non-taxation, reduced taxation or tax avoidance. *Article 6(1) and (2) of the MLI*	Yes	Yes	Same as New Zealand
	Preamble language – optional amendment The MLI allows countries to adopt the following optional amendment to the preamble to DTAs: "Desiring to further develop their economic relationship and to enhance their co-operation in tax matters," *Article 6(3) and (6) of the MLI*	No	No	Different to New Zealand. Adopt

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Treaty anti-abuse rules The MLI requires jurisdictions to introduce an anti-abuse rule into DTAs. Jurisdictions can meet this minimum requirement in one of three ways: 1. a principal purpose test (PPT) alone; 2. a PPT plus a "simplified limitation on benefits" (LOB) clause. The LOB is a mechanical provision that seeks to identify, through a series of black-letter tests, whether a person is genuinely entitled to the benefits of a DTA; or 3. enter into bilateral negotiations to include a detailed LOB provision plus a PPT or anti-conduit rules. New Zealand has indicated it wishes to adopt a PPT alone. The PPT is similar to New Zealand's domestic law GAAR and will deny treaty benefits if the principal purpose of an arrangement was to secure those benefits. Also, in officials' view, it generally covers the same treaty shopping issues as the alternative approaches. *Article 7 of the MLI*	Yes	Yes	Same as New Zealand
	Dividend transfer transactions The MLI introduces a provision that requires shares to be held for a minimum of 365 days for the shareholder to be entitled to the reduced withholding tax (WHT) rates on dividends. This is to stop shareholders buying shares temporarily to access the reduced WHT rates and then immediately selling them. *Article 8 of the MLI*	No	Yes	Same as New Zealand

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Land rich company rules The MLI introduces a treaty provision that strengthens the anti-abuse "land-rich company" test (land rich companies are companies whose assets are mainly land). Some treaties do not contain this provision at all, so the MLI also allows it to be inserted into those treaties. The new rule reinforces the position that the source jurisdiction can tax land held by non-resident owners in the other jurisdiction through corporate vehicles. To prevent artificial and temporary dilution of the amount of land held by a company just before sale, the MLI provision requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares. The MLI provision also ensures the same rule applies to other investment vehicles such as partnerships and trusts. *Article 9 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt generally, but do not adopt para. (b) for DTAs that already contain an equivalent provision.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Third-state PE rule The MLI introduces a treaty provision that denies treaty benefits in the case of income derived by a PE of a resident of one of the parties to the DTA, where that PE is situated in a low tax third-state. *Article 10 of the MLI*	No	Yes	Different to New Zealand Do not adopt.
	Right to tax own residents The MLI introduces a provision that preserves a jurisdiction's right to tax its own residents. For example, this rule prevents New Zealand residents engaged in a tax avoidance arrangement claiming a DTA prevents New Zealand from using the domestic law GAAR to impose tax. *Article 11 of the MLI*	No	Yes	Same as New Zealand.
3. Preventing the artificial avoidance of PE status	**Commissionaire arrangements and similar strategies** Currently, a number of artificial structures, including the civil law concept of a "commissionaire", arrangements whereby contracts which are substantially negotiated in a State are not concluded in that State because they are finalised or authorised abroad and arrangements whereby a related party who habitually concludes contracts on behalf of an enterprise is characterised as "independent agents", can be used to avoid having a PE in a jurisdiction. A new provision will deem non-residents using these structures to have a PE in the jurisdiction. *Articles 12 and 15 of the MLI*	No	Withheld under section 6(a) of the Official Information Act 1982 [redacted]	

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Specific activity exemptions – preparatory and auxiliary qualification Certain specific activities carried on in a jurisdiction are deemed **not** to constitute a PE (for example, premises used for simply storing goods or stock maintained for display or delivery). These specific carve-outs from the PE definition allowed quite substantial economic activities to fall within them. The MLI proposes clarifying that the specific carve-outs listed in the DTA must be subject to an additional requirement that they be "preparatory and auxiliary" in nature. There are two options for dealing with this issues – Option A (which New Zealand favours) which subjects all of the existing specific activities to an explicit "preparatory and auxiliary" test, and Option B, which does not subject the specific activities to the "preparatory and auxiliary" test (because these activities are considered to be inherently preparatory and auxiliary in nature), but subjects any other activity or combination of activities to the "preparatory and auxiliary" test. *Articles 13 and 15 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt Option A for DTAs that do not already contain an equivalent provision.
	Specific activity exemptions – Anti-fragmentation rule The MLI introduces an "anti-fragmentation" rule that will prevent an enterprise from dividing up all of its activities so that related parties each carry on a separate part of the business (that fall within the PE exceptions), but taken together they constitute a PE. *Articles 13 and 15 of the MLI*	No	Yes	Same as New Zealand.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Anti-contract splitting rule Currently a construction, installation or building project does not constitute a PE unless it last for more than 12 months (or six months in the case of many of New Zealand's treaties). Entities were abusing this time limit by having back-to-back contracts so they never exceeded the time threshold. Generally the contracts were undertaken by different companies within the same group of companies. The new an "anti-contract splitting" rule will aggregate related projects to prevent PE avoidance. *Articles 14 and 15 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt except for provisions of DTAs that cover exploration for or exploitation of natural resources.
4. Providing improved mechanisms for effective dispute resolution	**MAP – access to the CAs of either jurisdiction** In covered tax agreements that do not already have it, the MLI will introduce a provision allowing taxpayers to request mutual agreement procedure (MAP) in cases where they believe taxation is not in accordance with the treaty. If a MAP provision is already contained in a DTA, the MLI will amend it to allow taxpayers to approach the CA of *either* jurisdiction to resolve uncertainty as to how the DTA applies (New Zealand's DTAs currently contain MAP provisions, but taxpayers are only entitled to approach the CA of the jurisdiction of which they are a resident). *Article 16 of the MLI*	Yes	Yes	Same as New Zealand.
	MAP – corresponding adjustment Requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. *Article 17 of the MLI*	No	Yes	Similar substantive position to New Zealand. Adopt, except for DTAs that already contain an equivalent provision.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Australia's position
	Arbitration If, under the MAP process, the CAs do not agree on the correct interpretation of the DTA, the CAs can submit the matter to an independent arbitrator (or a panel of three arbitrators) for decision. The arbitrators will decide which of the CAs is correct. The CAs are generally bound by the decision of the arbitrators, but the taxpayer is not. Therefore, the taxpayer could pursue a court case if it disagrees with the arbitrators' decision. New Zealand's approach is to adopt what is referred to as "final offer" or "last best offer" arbitration (in Article 23(1)), but to accept "independent opinion" arbitration if the other party to the Covered Tax Agreement chooses this (by entering a reservation under Article 23(2)). In the case of "independent opinion" arbitration, New Zealand will adopt Article 24(2) and (3) which means that the arbitrators' decision will not be binding on the CAs if they come to an alternative resolution of all unresolved issues within 3 calendar months of the delivery of the arbitrators' decision. New Zealand also proposes to require undertakings of confidentiality by all parties involved in arbitration (Article 23(5)) and reserves the right not to include arbitration provisions in Covered Tax Agreements with jurisdictions that do not require the same (Article 23(6) and (7)). New Zealand intends to enter a free form reservation in respect to arbitration to carve out cases that involve the application of New Zealand's general anti-avoidance rule contained in section BG 1 of the Income Tax Act 2007. *Articles 18 – 26 of the MLI*	No	Yes	Very similar substantive position to New Zealand (including reserving on GAAR). But has not reserved the right to not adopt arbitration with jurisdictions which do not require confidentiality of proceedings.

Appendix C

New Zealand has 40 DTAs currently in force. The table below shows the coverage of the MLI across New Zealand's treaty network.

		DTA	Status
Covered tax agreements	1.	Australia	Covered tax agreement under the MLI
	2.	Belgium	Covered tax agreement under the MLI
	3.	Canada	Covered tax agreement under the MLI
	4.	Chile	Covered tax agreement under the MLI
	5.	China	Covered tax agreement under the MLI
	6.	Czech Republic	Covered tax agreement under the MLI
	7.	Denmark	Covered tax agreement under the MLI
	8.	Finland	Covered tax agreement under the MLI
	9.	France	Covered tax agreement under the MLI
	10.	Germany	Covered tax agreement under the MLI
	11.	Hong Kong (China)	Covered tax agreement under the MLI
	12.	India	Covered tax agreement under the MLI
	13.	Indonesia	Covered tax agreement under the MLI
	14.	Ireland	Covered tax agreement under the MLI
	15.	Italy	Covered tax agreement under the MLI
	16.	Japan	Covered tax agreement under the MLI
	17.	Malaysia	Covered tax agreement under the MLI
	18.	Mexico	Covered tax agreement under the MLI
	19.	Netherlands	Covered tax agreement under the MLI
	20.	Poland	Covered tax agreement under the MLI
	21.	Russia	Covered tax agreement under the MLI
	22.	Singapore	Covered tax agreement under the MLI
	23.	South Africa	Covered tax agreement under the MLI
	24.	Spain	Covered tax agreement under the MLI
	25.	Sweden	Covered tax agreement under the MLI
	26.	Switzerland	Covered tax agreement under the MLI
	27.	Turkey	Covered tax agreement under the MLI
	28.	United Kingdom	Covered tax agreement under the MLI
	29.	Korea	Covered tax agreement under the MLI
Not modified by the MLI	30.	Viet Nam	Withheld under section 6(a) of the Official Information Act 1982 [redacted]
	31.	Thailand	[redacted]
	32.	Philippines	[redacted]
	33.	Norway	[redacted]
	34.	Austria	[redacted]
	35.	United Arab Emirates	[redacted]
	36.	Papua New Guinea	[redacted]
	37.	Samoa	[redacted]
	38.	Taiwan	[redacted]
	39.	Fiji	[redacted]
	40.	United States	[redacted]

Appendix D

Submission	Officials' response
The dual resident entity provision in Article 4 should not be adopted. There are compliance costs associated with adopting this provision. Submitters felt many cases of dual resident entities were innocent. There are existing domestic law rules that address the mischief this rule aims to address.	• For some time OECD countries have been dissatisfied with the existing rule. This is partly because there is no consensus on how it should be interpreted and applied, and partly because there is concern about abuse. • Eight of New Zealand's DTAs (including the New Zealand-US DTA) already contain this provision and it has not, to our knowledge, been problematic. • This provision is the new OECD best practice and will be the international standard going forward in terms of the OECD Model Tax Convention. Australia is opting for it as well. • While there are some domestic law measures that prevent certain types of abuse by dual resident entities, they do not cover all situations. • New Zealand officials will manage the compliance costs and certainty issues by providing administrative guidance, in particular through a potential agreement with Australia on how the provision will be applied in practice between our two countries.
It is not necessary to adopt specific anti-avoidance measures (such as the contract splitting rule in Article 14, the dividend transfer rule in Article 8, and the land-rich company rule in Article 9), given there will be an overall general anti-abuse rule. These provisions will increase compliance costs.	• Specific provisions that address known abusive arrangements are desirable. • These provisions will become part of the OECD Model Tax Convention (sometimes as alternative provisions in the commentaries) and will be the starting point for future bilateral negotiations going forward. • Some of these provisions are already included in some of New Zealand's DTAs with no apparent issues. • Officials are looking at administrative measures to reduce compliance costs (e.g. administrative guidance on accepting quarterly valuations for the land-rich company provisions).
New Zealand should exclude from its list of covered tax agreements DTAs with countries who do not agree to adopt arbitration. This leaves open the possibility that "bad faith" adjustments will be made by a country under the	• This approach would reduce the efficacy of the MLI in enabling New Zealand to meet the OECD minimum standard as New Zealand would have to endeavour to undertake bilateral negotiations with these excluded jurisdictions, which could represent about half of New Zealand's DTAs, based on current draft notifications.

strengthened MLI provisions, with no ability for taxpayers to request binding arbitration of this decision.	• This would mean that – until bilateral negotiations can take place – the DTAs excluded on this basis would remain vulnerable to the BEPS techniques the MLI is designed to address. • On balance it is in New Zealand's interest to obtain the stronger DTA provisions, even if it is without the optional arbitration provisions. • We also note that many of New Zealand's DTAs already include a principal purpose test and wide permanent establishment rules, but no ability to pursue arbitration. Therefore this combination is already a feature of some of our existing DTAs and, from New Zealand's perspective, is not problematic. • We also have to expect that our treaty partners will apply DTA provisions in good faith. New Zealand's DTAs contain MAP processes to address any issues with this. • Finally, there is hope that, over time, more countries will adopt arbitration through the MLI or bilateral negotiations.
The rationale for New Zealand's reservation on section BG 1 of the Income Tax Act (the domestic law general anti-avoidance provision (GAAR)) in respect of arbitration is not clear. New Zealand should not reserve on section BG 1.	• New Zealand's domestic GAAR overrides DTAs under section BH 1 of the Income Tax Act 2007. • This means that, to the extent to which an arbitration decision was contrary to the GAAR, New Zealand would be unable to implement it. As arbitration is required to binding, New Zealand's inability to implement a decision that is contrary to the GAAR is problematic. • Therefore, New Zealand has taken the position (as have a number of other countries[3]), that a case will be excluded from arbitration to the extent that any unresolved issues relate to the application of a domestic law GAAR. • We do not agree that New Zealand should remove this reservation as it would give rise to potential conflicts with our domestic law.
New Zealand's section BG 1 reservation with respect to arbitration should also extend to MAP.	• This is not an option under the MLI. • Additionally, subjecting section BG 1 cases to MAP does not present the same domestic law conflict as binding arbitration.

[3] Australia, Austria, Canada, Germany, Finland, Ireland, Italy, Norway, Slovenia and Spain.

New Zealand should consider expanding the section BG 1 reservation to include the proposed PE avoidance rule (contained in the Government Discussion Document *BEPS – Transfer pricing and permanent establishment avoidance*)	• This is not yet in domestic law (or even approved by Cabinet), so it would not be appropriate to include this in a reservation at this time. This is something that could be added before New Zealand deposits its instrument of ratification after further consideration.
Listed companies may not be able to access arbitration as their continuous disclosure obligations (to the stock exchange) would not allow arbitration to be kept confidential	• Confidentiality of arbitration is core to its acceptance by a large number of jurisdictions (including New Zealand). • If New Zealand did not agree to confidentiality, other countries would not agree to arbitration with New Zealand. This would mean all taxpayers – not just listed companies – would be denied arbitration. • This is not in taxpayers' interests. • We expect that the level of disclosure could be managed to prevent the loss of arbitration.
DTAs under negotiation should be included at covered tax agreements.	• We have included DTAs currently under negotiation where the other party has agreed to this approach.
New Zealand would be justified in making the application of the MLI to a particular DTA conditional on acceptance that New Zealand taxpayers include PIEs and KiwiSaver schemes and confirmation that a look through entity is also entitled to DTA relief.	• This is not an option under the MLI. • Additionally, look through entities are also the subject of the fiscally transparent provision of the MLI which makes entitlement to treaty benefits conditional on an item of income being taxed in the state in which the entity is resident. A blanket approach to fiscally transparent entities is therefore inconsistent with the provision itself, New Zealand treaty policy and international best practice.
Why has New Zealand taken a different position from Australia on the third state PE rule (in Article 10)	• Australia has not yet made a decision on whether to adopt Article 10, so it is not yet clear whether we differ from Australia. • We have considered this provision – in particular how it applies to outbound investors – and believe it is principled, appropriate and balanced. • If the provision applies too widely or applies to innocent cases, there is competent authority discretion to grant treaty benefits.

Cabinet

Summary

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting: Approval for Signature and Ratification

Portfolio — **Revenue**

Purpose

This paper seeks approval of the text and agreement to sign the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the MLI).

Previous Consideration

In February 2017, EGI noted that there is significant global media and political concern about base erosion and profit shifting (BEPS), and agreed to the release of an officials' issues paper on *New Zealand's Implementation of the Multilateral Convention to Prevent BEPS* [EGI-17-MIN-0005].

Summary

Double tax agreements (DTAs) are bilateral international treaties which are designed to reduce tax impediments to cross-border services, trade, and investment without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. DTAs also enable tax administrations to support each other in the detection and prevention of tax evasion and avoidance.

The MLI (attached as **Annex 1**) proposes to quickly and efficiently amend a significant number of DTAs to take into account new treaty standards relating to treaty abuse and dispute resolution resulting from the OECD and G20's 15 point Action Plan on base erosion and profit shifting. New Zealand's MLI will cover 34 DTAs (i.e. those New Zealand holds with jurisdictions who are also signing the MLI). New Zealand's MLI position is discussed in **paragraphs 18-24**.

Submissions on the officials' issues paper concerning BEPS identified issues relating to the need for a New Zealand-specific approach (as the MLI is broadly drafted), the need for additional guidance and administrative resources to help taxpayers apply DTAs as modified by the MLI, and domestic law updates to support a smooth implementation of the MLI (discussed in **paragraph 29**).

Regulatory Impact Analysis

The Regulatory Impact Analysis and tax strategy teams at the Treasury consider that the National Impact Statement meets quality assurance criteria.

Baseline Implications

Data limitations prevent an accurate estimation of the impact on net tax revenue, though it is expected that the overall impact will be positive. There will be some administrative costs to IRD, which are expected to be small.

Legislative Implications The Income Tax Act 2007 provides for the regulation and giving of effect to DTAs. An Order in Council will give effect to the MLI.

Timing Issues The MLI signing ceremony is 7 June 2017. An Instrument of Full Powers will need be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI.

Announcement National communications relating to this matter will be managed by the office of the Minister of Revenue.

The text of the MLI, New Zealand's notifications and reservations, and the NIA will be tabled in the House of Representatives for Parliamentary treaty examination, as the MLI it is subject to ratification.

Proactive Release None proposed.

Consultation Paper prepared by Inland Revenue. MBIE and MFAT were consulted.

The Minister of Revenue indicates that discussion is not required with the government caucus, or with other parties represented in Parliament.

The Minister of Revenue recommends that Cabinet:

1 note that the Income Tax Act 2007 authorises the negotiation of, and giving effect to double tax agreements (DTAs) with other jurisdictions;

2 note that officials participated in the negotiation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the MLI), the text of which was formally adopted in November 2016;

3 note that the MLI will quickly and efficiently amend the majority of New Zealand's DTAs to include the recommended changes to tax treaties arising out of the OECD/G20 15 point Action Plan on base erosion and profit shifting;

4 approve the text of the MLI attached to the paper under CAB-17-SUB-0241 as Annex A, subject to any minor technical changes resulting from the process of translation or legal verification;

5 note that officials have finalised New Zealand's expected notifications and reservations in relation to the choices available in the MLI;

6 approve New Zealand's expected notifications and reservations attached to the paper under CAB-17-SUB-0241 as Annex B;

7 authorise the Minister of Finance and Minister of Revenue to approve any changes to the notifications and reservations as a result of developments in other jurisdictions' positions and any other minor technical changes;

8 agree that New Zealand sign the MLI;

9 note that an Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI, and that the Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature;

10 approve the extended National Interest Analysis (NIA) attached to the paper under CAB-17-SUB-0241 as Annex D;

11 note that the content of the NIA may change as a result of developments in other jurisdictions' positions between now and Parliamentary treaty examination;

12 note that the government will present any international treaty that is the subject of ratification to the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

13 agree that, following signature, the text of the MLI, New Zealand's notifications and reservations, and the NIA be tabled in the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

14 note that the MLI will be incorporated into New Zealand domestic law through an Order in Council with overriding effect made pursuant to section BH 1 of the Income Tax Act 2007;

15 invite the Minister of Revenue to instruct the Parliamentary Counsel Office to draft the Order in Council to give effect to the MLI, following signature and completion of the Parliamentary treaty examination process;

16 authorise officials, following signature, completion of the Parliamentary treaty examination process, and promulgation of the Order in Council, to bring the MLI into force by depositing New Zealand's instrument of ratification and list of confirmed notifications and reservations with the OECD Depositary.

Jenny Vickers
for Secretary of the Cabinet

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The Cabinet

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Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet

Signature and ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Proposal

1. This paper proposes that Cabinet authorises New Zealand's signature of, and the steps necessary to ratify and bring into force, the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("the Multilateral Instrument" or "MLI"). The full text of the MLI is attached as Annex A and a full list of New Zealand's proposed notifications and reservations to be submitted at the time of signature and confirmed upon ratification is attached as Annex B. A table showing the MLI's coverage of New Zealand's double tax agreement ("DTA") network is attached as Annex C.

Executive summary

2. DTAs are bilateral international treaties designed to reduce tax impediments to cross-border services, trade and investment without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. DTAs also enable tax administrations to assist each other in the detection and prevention of tax evasion and avoidance. Section BH 1 of the Income Tax Act 2007 provides for the negotiation of and giving of effect to DTAs with other countries. New Zealand currently has 40 DTAs in force, primarily with major trading and investment partners.

3. The MLI is a multilateral international treaty that proposes to quickly and efficiently amend a significant number of DTAs around the world to take into account new treaty standards relating to treaty abuse and dispute resolution that have arisen out of the Organisation for Economic Co-operation and Development (OECD) and G20's 15-point Action Plan on base erosion and profit shifting ("BEPS"). It allows New Zealand to update the majority of its 40 DTAs without entering into bilateral negotiations with each of its treaty partners.

4. In May 2016, Cabinet considered the MLI as part of the New Zealand Government's response to BEPS (CAB-16-MIN-0218 refers). In February 2017, Cabinet approved the release of an officials' issues paper seeking submissions on New Zealand's implementation of the MLI (EGI-17-MIN-0005, CAB-17-MIN-0041 refers).

5. This paper seeks Cabinet approval for New Zealand to sign the MLI at a signing ceremony arranged by the OECD to be held in Paris on 7 June 2017. As the MLI is subject to ratification it must be presented to the House of Representatives for Parliamentary treaty examination in accordance with Standing Order 397, this paper also proposes that Cabinet approves the text of an extended National Interest Analysis ("NIA") for submission to Parliament. The extended NIA is attached as Annex D. This paper also proposes that Cabinet authorises the steps necessary to give effect to the provisions of the MLI under New Zealand

law and, after those steps have been successfully completed, authorise officials to ratify the MLI by depositing an instrument of ratification, along with New Zealand's list of confirmed notifications and reservations, with the MLI Depositary (the OECD).

Background

6. DTAs are bilateral international treaties designed to reduce tax impediments to cross-border services, trade and investment without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion. DTAs also enable tax administrations to assist each other in the detection and prevention of tax evasion and avoidance. Section BH 1 of the Income Tax Act 2007 provides for the negotiation of and giving of effect to DTAs with other countries. New Zealand currently has 40 DTAs in force, primarily with major trading and investment partners.

7. While DTAs are beneficial for taxpayers, investors and governments themselves, there is the potential for these bilateral agreements to be misused to reduce or eliminate a multinational's worldwide tax. Misuse of DTAs in this way has been a feature of a number of cross-border tax avoidance arrangements.

8. The misuse of DTAs forms part of a wider problem referred to as BEPS, which has been the focus of significant global media and political attention since late 2012, following evidence suggesting that some multinationals pay little or no tax anywhere in the world.

9. BEPS is a global problem as many BEPS strategies exploit technical differences between different countries' tax rules, so New Zealand has been working with the OECD and G20 to develop a co-ordinated global solution to address BEPS through the 15-point OECD/G20 BEPS Action Plan.

10. A number of the items on the OECD/G20 BEPS Action Plan address the misuse of DTAs and can only be implemented through changes to DTAs themselves. These are:

- preventing the granting of treaty benefits in inappropriate circumstances (Action 6);
- preventing the artificial avoidance of permanent establishment status (Action 7);
- neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2); and
- providing improved mechanisms for effective dispute resolution (Action 14).

11. Some of these solutions are "minimum standards" that countries that commit to solving BEPS are expected to adopt. Other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following adoption of the OECD/G20 BEPS Action Plan.

12. Countries, including New Zealand, were presented with the difficulty of how to quickly and efficiently implement these measures without requiring the bilateral renegotiation of several thousand existing DTAs, which could take several years (or even potentially decades). For this reason, the Multilateral Instrument was developed under Action 15 of the OECD/G20 BEPS Action Plan to swiftly amend the DTAs of all participating jurisdictions.

The Multilateral Instrument

13. The MLI is a multilateral international treaty that proposes to quickly and efficiently amend a significant number of DTAs around the world to take into account new treaty standards relating to treaty abuse and dispute resolution that have arisen out of the OECD/G20 BEPS Action Plan, as outlined in paragraph 10. It allows New Zealand to update the majority of its 40 DTAs without entering into bilateral negotiations with each of its treaty partners.

14. New Zealand's treaty negotiation resources are limited and to update New Zealand's entire DTA network would take several years, if not decades, particularly as many of New Zealand's treaty partners would likely place greater importance on updating more significant treaties. This would limit New Zealand's likelihood of being able to meet the OECD minimum standard in a timely fashion.

15. The text of the MLI was developed by the OECD Ad Hoc Group consisting of officials from more than 100 participating jurisdictions, including New Zealand, and was formally adopted by the OECD in November 2016. Experts in both international tax and public international law participated in the OECD Ad Hoc Group that developed the MLI to ensure that it works as intended.

16. The MLI is flexible and allows jurisdictions to choose:

- which of their existing DTAs they wish to modify through the MLI;
- alternative ways of meeting BEPS minimum standards on treaty abuse and dispute resolution; and
- whether they want to adopt the OECD-recommended provisions for non-minimum standards.

17. Within some of these provisions, there are alternative ways of addressing BEPS concerns and the ability for countries to enter a variety of reservations.

New Zealand's proposed MLI positions

18. To make the best use of the MLI, New Zealand's proposed strategy is to include the majority of its DTAs within the scope of the MLI and to adopt as many of the MLI provisions as possible, where they are in line with New Zealand's overall treaty policy. This will give New Zealand the best chance of strengthening its DTAs with as many jurisdictions as possible and will introduce consistency across New Zealand's treaty network.

19. Of New Zealand's 40 in-force DTAs, New Zealand has nominated 34 to be covered by the MLI. Many of these DTAs were concluded in the 1970s and 1980s and do not reflect modern treaty standards, even before the work on BEPS was completed. The six DTAs that have not been listed are with jurisdictions who will not be signing the MLI. To be modified by the MLI, both New Zealand and the other jurisdiction must elect for the MLI to apply to the DTA (if there is a match, then the DTA is a "covered tax agreement"). Based on current draft notifications, New Zealand is expected to have 28 covered tax agreements. See Annex C. While this list is not final, it provides a fairly good indication of the likely coverage of the MLI. Final coverage will not be confirmed until each jurisdiction deposits its instrument of ratification with the OECD Depositary.

20. As noted in paragraph 18, New Zealand's proposed strategy is to adopt as many of the MLI provisions as possible. This is because they are base protection measures that are in line with New Zealand's existing treaty policy (which has a greater source state emphasis than the OECD Model Tax Convention on which the New Zealand negotiating model is based). For example, New Zealand generally takes a broader approach in its DTAs than the current OECD Model Tax Convention in determining whether a permanent establishment exists. This means that the recommendations under Action 7 (preventing the artificial avoidance of permanent establishment status) of the OECD/G20 BEPS Action Plan which are contained in Articles 12 to 15 of the MLI are not contrary to New Zealand's general treaty policy and, in New Zealand's view, represent an improvement to the OECD Model Tax Convention.

Withheld under section 6(a) of the Official Information Act 1982

[redacted]

22. In addition to the proposed changes to the concept of a permanent establishment, it is proposed that New Zealand signs up to the provisions that relate to the following common problems identified with the OECD Model Tax Convention:

- Fiscally transparent entities (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The provision in Article 3 clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident.

- Dual resident entities can be used to take advantage of arbitrage opportunities by manipulating the current "place of effective management" test. The proposed provision in Article 4 will require competent authorities to agree the residence status of a dual resident entity. If there is no agreement, then treaty benefits will be denied, or only granted to the extent to which the competent authorities can agree.

- In the OECD Model Tax Convention and in many of New Zealand's modern treaties, a lower withholding tax rate is available where the shareholder owns more than a certain proportion of the company's shares. The MLI provision in Article 8 requires shares to be held for a minimum of 365 days for the shareholder to be entitled to reduced withholding tax rates on dividends. This prevents shareholders buying shares and holding them temporarily in order to access lower withholding rates.

- Investors can hold land through companies and dispose of the shares in the company to avoid paying tax on the disposal of that land. Many treaties contain a "land-rich company rule" which allows the source jurisdiction to tax income derived from land when the majority of a company's assets consist of land. To prevent artificial and temporary dilution of the amount of land held by a company just before sale, the provision in Article 9 requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares and extends the rule to interests in other entities such as partnerships and trusts.

- Permanent establishments can be established in third states to exploit low tax rates and branch exemptions. Article 10 of the MLI introduces a provision that denies treaty benefits in the case of income derived by a permanent establishment of one of the parties to the DTA, where that permanent establishment is situated in a low tax third state.

- Article 11 introduces a provision that preserves a jurisdiction's right to tax its own residents. For example, this provision would prevent a New Zealand resident who is engaged in a tax avoidance arrangement from claiming that a DTA prevents New Zealand from using its domestic general anti-avoidance rule to impose tax.

23. In addition to addressing these specific BEPS concerns, Article 6 of the MLI proposes to amend the preamble to DTAs to confirm that they are not intended to be used to generate double non-taxation, and under Article 7, New Zealand has selected the option of adding a principal purpose test to its DTAs. The principal purpose test is a general anti-abuse rule that applies to the whole DTA. Both Articles 6 and 7 form part of the OECD minimum standard.

24. In addition to these base protection measures, New Zealand is signing up to taxpayer friendly measures relating to the mutual agreement procedure ("MAP") and the availability of arbitration as a form of dispute resolution. These measures are a result of the work on Action 14 of the G20/OECD BEPS Action Plan relating to the improvement of mechanisms for effective dispute resolution. The key provisions are as follows:

- Article 16 of the MLI introduces a provision allowing taxpayers to request MAP where they believe taxation is not in accordance with the treaty. This is a new OECD minimum standard. While the majority of New Zealand's DTAs contain MAP provisions, the MLI will amend these provisions to allow taxpayers to approach the competent authority of either jurisdiction (currently they only permit a case to be presented to the competent authority of the taxpayer's country of residence).
- Article 16 also creates a new minimum standard regarding time limits for bringing a case to MAP and time limits for implementing a solution.
- Article 17 requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. This provision is already found in most of New Zealand's DTAs except for New Zealand's oldest treaties.
- New Zealand has also opted to apply Part VI of the MLI, which will introduce arbitration as a means of dispute resolution. If a solution cannot be reach under MAP, taxpayers have the ability to request that unresolved issues can be taken to arbitration. New Zealand has already agreed to arbitration in its treaties with Australia and Japan. New Zealand's experience is that the arbitration facility is very rarely used, but it acts as an incentive for the competent authorities of two jurisdictions to come to an agreement within the required time period for MAP.

Implementation issues and consultation

25. The main difficulty in implementing the provisions of MLI compared with amending protocols stems from the fact that the provisions in the MLI have been drafted more broadly than they otherwise would for an amending protocol to take account of the fact that the MLI must be able to apply to not one DTA, but several thousand.

26. This means that there can be some ambiguity in how the MLI applies to a particular DTA. This ambiguity is mitigated in many cases as a MLI provision will only replace the corresponding existing provision if both treaty partners notify the same provision. However, compliance costs may still be incurred as taxpayers will need to consider the DTA and MLI alongside both jurisdictions' notifications and reservations.

27. While officials generally do not consult on the content of tax treaties, due to the unusual nature of the MLI, public feedback was sought on potential implementation issues related to the Multilateral Instrument. An officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. Submissions closed on 7 April 2017 and 5 were received (from EY, KPMG, PwC, Corporate Taxpayers Group ("CTG") and Chartered Accountants Australia and New Zealand ("CA ANZ")). Two stakeholder workshops were held on 27 and 28 March 2017 with CTG and CA ANZ to enable officials to better understand practitioners' concerns.

28. Two of the submissions supported the adoption of the MLI as the most effective way to implement the treaty related BEPS recommendations. One submission acknowledged that the New Zealand Government has the constitutional ability to decide New Zealand's tax treaty position and it therefore makes sense to achieve this in the shortest time at the least cost through the MLI. One submission acknowledged that participating in OECD and G20 initiatives to target BEPS is a key focus for the government, while not explicitly supporting the adoption. The final submission did not express an overall view on adoption, but submitted that New Zealand should not adopt all of the optional provisions.

29. The main issues raised in submissions relate to:

a. **substantive positions taken by New Zealand**. Although consultation was intended to focus on implementation issues, submitters did comment on the substance of the new provisions in the MLI. Most submitters were generally supportive of New Zealand's adoption of the MLI and a number supported the proposals to take up most of the MLI provisions as an efficient way to amend our treaty network, but some submitters raised concerns about specific provisions. One point of contention among submitters was the proposal to adopt Article 4 of the MLI, relating to dual-resident entities (refer paragraph 22 above). However, this new rule is being adopted by many countries as a means of curbing certain forms of treaty abuse. It is also consistent with the position New Zealand has taken in a number of bilateral treaties. Officials are exploring ways to reduce compliance costs associated with this provision. Another concern related to one aspect of the new permanent establishment provisions which might lead to more taxation of New Zealanders operating offshore. However, New Zealand's adoption of this provision would be consistent with both the proposals contained in the recent Government discussion document titled *BEPS – Transfer pricing and permanent establishment avoidance* and the long-term direction of New Zealand's tax treaty policy.

b. **requests for additional guidance and administrative resources** to help taxpayers apply DTAs as modified by the MLI (including requests for Inland Revenue to produce consolidated versions of New Zealand's DTAs as modified by the MLI). New Zealand officials have already been working with their Australian counterparts to scope what administrative guidance could be jointly developed to assist taxpayers. Publishers may produce consolidated texts as they currently do with amending protocols and original DTAs. In addition to this, New Zealand Inland Revenue officials are continuing discussions with overseas counterparts to determine what additional certainty the competent authorities may be able to provide (for example, through a memorandum of understanding which sets out in more detail how each MLI provision applies to the DTA).

c. **technical domestic law changes** needed to implement the MLI smoothly. Officials are considering these suggestions and will report separately to Ministers on what domestic law changes may be required before the MLI comes into effect.

Next steps

30. Subject to Cabinet's approval for New Zealand to sign the MLI, we propose that the Minister of Revenue signs the MLI at a signing ceremony arranged by the OECD to be held in Paris on 7 June 2017. At the signing ceremony, New Zealand will also need to present its expected notifications and reservations.

31. An Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI. The Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature.

32. Standing Order 397 provides that the Government will present any international treaty that is the subject of ratification by New Zealand to the House of Representatives for treaty examination by Select Committee. Accordingly, after signature, it is proposed that the MLI be submitted to the House of Representatives for Parliamentary treaty examination. For this purpose, an extended NIA has been drafted and is attached at Annex D. This paper seeks Cabinet approval of the extended NIA so that it can be submitted to Parliament as part of the Parliamentary treaty examination process.

33. The MLI will be implemented by an Order in Council made pursuant to section BH 1 of the Income Tax Act 2007 which has overriding effect in relation to other legislation relating to tax and the exchange of information that relates to tax. Subject to satisfactory completion of Parliamentary treaty examination, this paper also seeks Cabinet approval for me to issue drafting instructions for an Order in Council to implement the MLI into New Zealand domestic law.

34. Article 34 provides that the MLI will enter into force for New Zealand once New Zealand has deposited its instrument of ratification. New Zealand will be in a position to deposit its instrument of ratification following the completion of all domestic procedures for entry into force. Subject to the successful promulgation of an Order in Council, this paper seeks Cabinet approval for officials to ratify the MLI by depositing New Zealand's instrument of ratification with the MLI Depositary. New Zealand will also need to confirm its final notifications and reservations at this point in time.

Consultation

35. Tax policy officials and the Ministry of Foreign Affairs and Trade were consulted in the preparation of this Cabinet paper.

36. In addition, an officials' issues paper titled *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS* was released on 3 March 2017. Submissions closed on 7 April 2017 and 5 were received. Officials met with interested stakeholders. These submissions and views are summarised in paragraphs 26 to 29 above.

Financial implications

37. Normally, new DTAs or amending protocols constrain New Zealand from taxing certain income and limit the rate at which tax on passive income (dividends, interest, and royalties) can be imposed and therefore result in the reduction of New Zealand tax. This upfront revenue cost is then typically offset by other factors (for example, through reduced need to allow foreign tax credits).

38. The MLI differs in that its provisions are typically base protection measures which increase New Zealand's ability to tax inbound investment and equips New Zealand with a whole-of-treaty anti-abuse rule to prevent tax avoidance through the use of DTAs. This may result in more tax paid by non-residents in New Zealand. However, as the provisions are reciprocal, the MLI may increase the amount of foreign income tax paid by New Zealand residents with investments and business operations overseas. This could decrease the amount of New Zealand income tax paid on that foreign income as a foreign tax credit is provided for foreign income tax paid.

39. Data limitations prevent officials from accurately estimating the actual impact on net tax revenue. However, as New Zealand is a capital importer and the MLI covers the majority of New Zealand's DTA network, it is expected that overall impact on tax revenue will be positive.

40. In terms of costs borne by Inland Revenue, there will be costs associated in administering the arbitration provisions of the MLI and some of the provisions that require competent authority agreement. However, these are expected to be relatively small. The existence of arbitration provides a strong incentive for tax authorities to resolve issues under the mutual agreement procedure before arbitration can be triggered. New Zealand's DTAs with Australia and Japan already provide for arbitration and New Zealand's experience is that very few cases have been brought by taxpayers under the mutual agreement procedure and almost all of these have been settled within the required time period, regardless of whether the DTA provides for arbitration.

Human rights

41. No inconsistencies with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993 have been identified.

Legislative implications

42. The MLI must be given effect by Order in Council, pursuant to section BH 1 of the Income Tax Act 2007.

43. Accordingly this paper seeks approval for an Order in Council to be drafted and submitted to Cabinet following the signing of the MLI and the completion of the Parliamentary treaty examination process.

Regulatory impact analysis

44. As this proposal has regulatory implications (it requires an Order in Council), the Regulatory Impact Analysis (RIA) requirements apply. However, as this paper relates to an international treaty, an extended NIA has been prepared (see Annex D) rather than a separate Regulatory Impact Statement.

45. The extended NIA was prepared by Inland Revenue. The extended NIA was circulated with this paper to the Treasury and the Ministry of Foreign Affairs and Trade for departmental consultation.

46. As this proposal has regulatory implications (it requires an Order in Council), the Regulatory Impact Analysis (RIA) requirements apply. However, as this paper relates to an international treaty, an extended NIA has been prepared (see Annex D) in accordance with the RIA requirements.

47. The extended NIA was prepared by Inland Revenue. The extended NIA was circulated with this paper to the Treasury and the Ministry of Foreign Affairs and Trade for departmental consultation.

48. The Regulatory Impact Analysis Team (RIAT) and the tax strategy team in the Treasury have jointly reviewed the extended NIA prepared by Inland Revenue and associated supporting material, and considers that the information and analysis summarised in the extended NIA meets the quality assurance criteria.

49. The extended NIA compares the benefits and costs of signing the treaty relative to taking no action or other potential approaches to amending DTAs, and provides sufficient analysis to support the proposals.

50. In part because provisions in the MLI are drafted broadly it has been difficult to project the revenue and compliance impacts from the treaty. RIAT recommends ongoing monitoring and evaluation of the impacts of the MLI as part of the Government's response to BEPS to ensure that any unintended consequences are known.

Publicity

51. It is proposed that New Zealand participates in the signing ceremony arranged by the OECD to be held in Paris on 7 June 2017. Appropriate media statements and announcements will be arranged once details have been finalised. The text of the MLI and New Zealand's notifications and reservations will be publicly available on Inland Revenue's Tax Policy website. The extended NIA will be publicly available on the Parliamentary website following Parliamentary treaty examination.

52. It is expected that the OECD will also arrange its own publicity for the signing ceremony and will make all signatories' reservations and notifications publicly available following the signing ceremony.

Recommendations

53. We recommend that the Cabinet:

1. **note** that the Income Tax Act 2007 authorises the negotiation of, and giving effect to double tax agreements ("DTAs") with other jurisdictions;

2. **note** that officials participated in the negotiation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "MLI"), the text of which was formally adopted in November 2016;

3. **note** that the MLI will quickly and efficiently amend the majority of New Zealand's DTAs to include the recommended changes to tax treaties arising out of the OECD/G20 15 point Action Plan on base erosion and profit shifting;

4. **approve** the text of the MLI attached to the Cabinet paper as Annex A (subject to any minor technical changes resulting from the process of translation or legal verification);

5. **note** that officials have finalised New Zealand's expected notifications and reservations in relation to the choices available in the MLI;

6. **approve** New Zealand's expected notifications and reservations attached to the Cabinet paper as Annex B;

7. **delegate** to the Minister of Finance and Minister of Revenue the authority to approve any changes to the notifications and reservations as a result of developments in other jurisdictions' positions and any other minor technical changes;

8. **agree** that New Zealand sign the MLI;

9. **note** that an Instrument of Full Powers will need to be obtained from the Minister of Foreign Affairs to enable the Minister of Revenue to sign the MLI. The Ministry of Foreign Affairs and Trade will prepare this Instrument and arrange for its signature;

10. **approve** the extended National Interest Analysis ("NIA") attached to the Cabinet paper as Annex D;

11. **note** the content of the NIA may change as a result of developments in other jurisdictions' positions between now and Parliamentary treaty examination;

12. **note** that the Government will present any international treaty that is the subject of ratification to the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

13. **agree** that, following signature, the text of the MLI, New Zealand's notifications and reservations, and the NIA be tabled in the House of Representatives for Parliamentary treaty examination, in accordance with Standing Order 397;

14. **note** that the MLI will be incorporated into New Zealand domestic law through an Order in Council with overriding effect made pursuant to section BH 1 of the Income Tax Act 2007;

15. **invite** the Minister of Revenue to instruct the Parliamentary Counsel Office to draft the Order in Council to give effect to the MLI, following signature and completion of the Parliamentary treaty examination process;

16. **authorise** officials, following signature, completion of the Parliamentary treaty examination process, and promulgation of the Order in Council to bring the MLI into force by depositing New Zealand's instrument of ratification and list of confirmed notifications and reservations with the OECD Depositary.

Hon Steven Joyce Minister of Finance ____/_____/__________ Date	**Hon Judith Collins** Minister of Revenue ____/_____/__________ Date

Annex A

Text of the MLI

Annex B

New Zealand's notifications and reservations

Annex C

New Zealand has 40 DTAs currently in force. The table below shows the coverage of the MLI across New Zealand's treaty network (as at 9 May 2017).

	DTA	
Covered tax agreements	1.	Australia
	2.	Belgium
	3.	Canada
	4.	Chile
	5.	China
	6.	Czech Republic
	7.	Denmark
	8.	Finland
	9.	France
	10.	Germany
	11.	Hong Kong (China)
	12.	India
	13.	Indonesia
	14.	Ireland
	15.	Italy
	16.	Japan
	17.	Malaysia
	18.	Mexico
	19.	Netherlands
	20.	Poland
	21.	Russia
	22.	Singapore
	23.	South Africa
	24.	Spain
	25.	Sweden
	26.	Turkey
	27.	United Kingdom
	28.	Korea
Not modified by the MLI	29.	Switzerland
	30.	Viet Nam
	31.	Thailand
	32.	Philippines
	33.	Norway
	34.	Austria
	35.	United Arab Emirates
	36.	Papua New Guinea
	37.	Samoa
	38.	Taiwan
	39.	Fiji
	40.	United States

Annex D

Extended NIA

Annex A – Text of the Multilateral Instrument

The text of Multilateral Instrument is available on OECD’s website at http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

New Zealand

Status of List of Reservations and Notifications at the Time of Signature

This document contains a provisional list of expected reservations and notifications to be made by New Zealand pursuant to Articles 28(7) and 29(4) of the Convention.

Article 2 – Interpretation of Terms

Notification - Agreements Covered by the Convention

Pursuant to Article 2(1)(a)(ii) of the Convention, New Zealand wishes the following agreements to be covered by the Convention:

No	Title	Other Contracting Jurisdiction	Original/ Amending Instrument	Date of Signature	Date of Entry into Force
1	Convention between Australia and New Zealand for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion	Australia	Original	26-6-2009	19-03-2010
2	Agreement between New Zealand and the Republic of Austria with respect to taxes on income and on capital	Austria	Original	21-09-2006	01-12-2007
3	Convention Between the Government of New Zealand and the Government of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income	Belgium	Original	15-09-1981	08-12-1983
			Amending Instrument (a)	07-12-2009	N/A
4	Convention between New Zealand and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Canada	Original	03-05-2012	26-06-2015
			Amending Instrument (a)	12-09-2014	26-06-2015
5	Convention between New Zealand and the Republic of Chile for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Chile	Original	10-12-2003	21-06-2006
6	Agreement between the Czech Republic and New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Czech Republic	Original	26-10-2007	29-08-2008
7	Convention between the Government of New Zealand and the Government of the Kingdom of Denmark for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Denmark	Original	10-10-1980	22-06-1981
			Amending Instrument (a)	12-03-1985	22-07-1985
8	Convention between the Government of New Zealand and the Government of Finland for the	Finland	Original	12-03-1982	22-09-1984
			Amending Instrument	05-12-1986	08-05-1988

	avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income		(a)		
9	Convention between the Government of New Zealand and the Government of the French Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	France	Original	30-11-1979	19-03-1981
10	Agreement between New Zealand and the Federal Republic of Germany for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and certain other taxes	Germany	Original	20-10-1978	21-12-1980
11	Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Hong Kong	Original	01-12-2010	09-11-2011
12	Convention between the Government of New Zealand and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	India	Original	17-10-1986	03-12-1986
			Amending Instrument (a)	29-08-1996	09-01-1997
			Amending Instrument (b)	21-06-1999	17-12-1999
			Amending Instrument (c)	26-10-2016	N/A
13	Agreement between the Government of New Zealand and the Government of the Republic of Indonesia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Indonesia	Original	25-03-1987	24-06-1988
14	Convention between the Government of New Zealand and the Government of Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains	Ireland	Original	19-09-1986	26-09-1988
15	Convention between the Government of New Zealand and the Government of the Republic of Italy for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion	Italy	Original	06-12-1979	23-03-1983

16	Convention between New Zealand and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Japan	Original	10-12-2012	25-10-2013
17	Agreement between the Government of New Zealand and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Malaysia	Original	19-03-1976	02-09-1976
			Amending Instrument (a)	14-07-1994	01-07-1996
			Amending Instrument (b)	06-11-2012	12-01-2016
18	Agreement between the Government of New Zealand and the Government of the United Mexican States for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Mexico	Original	16-11-2006	16-06-2007
19	Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Netherlands	Original	15-10-1980	18-03-1981
			Amending Instrument (a)	20-12-2001	22-08-2004
20	Convention between New Zealand and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Certain other Taxes	Norway	Original	20-04-1982	31-03-1983
			Amending Instrument (a)	16-06-1998	16-07-1998
21	Convention between the Government of New Zealand and the Government of the Republic of the Philippines for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Philippines	Original	29-04-1980	14-05-1981
			Amending Instrument (a)	21-02-2002	02-10-2008
22	Agreement between New Zealand and the Republic of Poland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Poland	Original	21-04-2005	16-08-2006
23	Agreement between the Government of New Zealand and the Government of the Russian Federation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Russian Federation	Original	05-09-2000	04-07-2003
24	Agreement Between The Government Of New Zealand And	Singapore	Original	21-08-2009	12-08-2010

	The Government Of The Republic Of Singapore For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income				
25	Agreement between the Government of New Zealand and the Government of the Republic of South Africa for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	South Africa	Original	06-02-2002	23-07-2004
26	Agreement between the Government of New Zealand and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Spain	Original	28-07-2005	31-07-2006
27	Convention between the Government of New Zealand and the Government of Sweden for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Sweden	Original	21-02-1979	14-11-1980
28	Convention between New Zealand and the Swiss Confederation for the avoidance of double taxation with respect to taxes on income	Switzerland	Original	06-06-1980	21-11-1981
29	Agreement between the Government of New Zealand and the Government of the Kingdom of Thailand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income	Thailand	Original	22-10-1998	14-12-1998
30	Agreement between the Government of New Zealand and the Government of the Republic of Turkey for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Turkey	Original	22-04-2010	28-07-2011
31	Convention between the Government of New Zealand and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains	United Kingdom	Original	04-08-1983	16-03-1984
			Amending Instrument (a)	22-12-1983	22-12-1983
			Amending Instrument (b)	04-11-2003	23-07-2004
			Amending Instrument (c)	07-11-2007	28-08-2008
32	Agreement between the	Viet Nam	Original	05-08-2013	05-05-2014

	Government of New Zealand and the Government of the Socialist Republic of Viet Nam for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income				
33	Agreement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	China	Original	16-09-1986	17-12-1986
			Amending Instrument (a)	7-10-1997	22-03-2000
34	Convention between the Government of New Zealand and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income	Republic of Korea	Original	6-10-1981	22-04-1983
			Amending Instrument (a)	14-07-1997	10-10-1997

Article 3 – Transparent Entities

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 3(6) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 3(4)

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 1(2)
5	Chile	Article 4(4)
16	Japan	Article 4(5)

Article 4 – Dual Resident Entities

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 4(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 4(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 4(3)
2	Austria	Article 4(3)
3	Belgium	Article 4(3)
4	Canada	Article 4(5)
5	Chile	Article 4(3)
6	Czech Republic	Article 4(3)
7	Denmark	Article 4(3)
8	Finland	Article 4(3)
9	French Republic	Article 4(3)
10	Germany	Article 4(3)
11	Hong Kong (China)	Article 4(3)
12	India	Article 4(3)
13	Indonesia	Article 4(3)
14	Ireland	Article 4(3)
15	Italy	Article 4(3)
16	Japan	Article 4(3); Protocol (3)
17	Malaysia	Article 3(3)
18	Mexico	Article 4(4)
19	Netherlands	Article 4(3)
20	Norway	Article 4(3)
21	Philippines	Article 4(3)
22	Poland	Article 4(4)
23	Russian Federation	Article 4(4)
24	Singapore	Article 4(3)
25	South Africa	Article 4(3)
26	Spain	Article 4(3)
27	Sweden	Article 3(3)
28	Switzerland	Article 4(3)
29	Thailand	Article 4(4)
30	Turkey	Article 4(3)
31	United Kingdom	Article 4(3)
32	Viet Nam	Article 4(3)
33	China	Article 4(3)
34	Republic of Korea	Article 4(3)

Article 6 – Purpose of a Covered Tax Agreement

Notification of Existing Preamble Language in Listed Agreements

Pursuant to Article 6(5) of the Convention, New Zealand considers that the following agreements are not within the scope of a reservation under Article 6(4) and contain preamble language described in Article 6(2). The text of the relevant preambular paragraph is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Preamble Text
1	Australia	Desiring to conclude a Convention for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion,
2	Austria	desiring to conclude an Agreement with respect to taxes on income and on capital,
3	Belgium	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
4	Canada	DESIRING to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
5	Chile	desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income;
6	Czech Republic	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
7	Denmark	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
8	Finland	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
9	French Republic	desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
10	Germany	Desiring to conclude an Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Certain Other Taxes,
11	Hong Kong (China)	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
12	India	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
13	Indonesia	Desiring to conclude an Agreement for the avoidance of

		double taxation and the prevention of fiscal evasion with respect to taxes on income,
14	Ireland	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains;
15	Italy	desiring to conclude a convention for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion.
16	Japan	Desiring to conclude a new Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
17	Malaysia	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
18	Mexico	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
19	Netherlands	Desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
20	Norway	Desiring to conclude a Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income and certain other taxes,
21	Philippines	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
22	Poland	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
23	Russian Federation	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
24	Singapore	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
25	South Africa	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
26	Spain	desiring to conclude an Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income,
27	Sweden	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
28	Switzerland	Desiring to conclude a Convention for the avoidance of double taxation with respect to taxes on income
29	Thailand	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
30	Turkey	desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with

		respect to taxes on income,
31	United Kingdom	Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains;
32	Viet Nam	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,
33	China	Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income;
34	Republic of Korea	Desiring to conclude a Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income,

Article 7 – Prevention of Treaty Abuse

Notification of Choice of Optional Provisions

Pursuant to Article 7(17)(b) of the Convention, New Zealand hereby chooses to apply Article 7(4).

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 7(17)(a) of the Convention, New Zealand considers that the following agreements are not subject to a reservation under Article 7(15)(b) and contain a provision described in Article 7(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 10(9); Article 11(9); Article 12(7); Article 14(5), second sentence
4	Canada	Article 10(9); Article 11(10); Article 12(7)
5	Chile	Article 22(2)
11	Hong Kong	Article 10(8); Article 11(10); Article 12(7)
14	Ireland	Article 13(7); Article 14(7)
16	Japan	Article 23
24	Singapore	Article 10(6); Article 12(7)
31	United Kingdom	Article 11(6); Article 12(9); Article 13(7); Article 21A(5); Article 22(5)
32	Viet Nam	Article 10(6); Article 11(7); Article 12(7)
33	China	Article 4(1)(a) of (a)

Article 8 – Dividend Transfer Transactions

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 8(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 8(1) that is not subject to a reservation described in Article 8(3)(b). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 10(2)(a) and (3)
4	Canada	Article 10(2)(a)
11	Hong Kong	Article 10(2)(a) and (3)
16	Japan	Article 10(3)
18	Mexico	Protocol (9)
24	Singapore	Article 10(2)(a)
30	Turkey	Article 10(2)(a)
32	Viet Nam	Article 10(2)(a)

Article 9 – Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property

Notification of Choice of Optional Provisions

Pursuant to Article 9(8) of the Convention, New Zealand hereby chooses to apply Article 9(4).

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 9(7) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 9(1). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 13(4)
2	Austria	Article 13(4)
4	Canada	Article 13(4)
6	Czech Republic	Article 13(4)
9	French Republic	Article 13(4)
10	Germany	Protocol (5)(a), first sentence
11	Hong Kong (China)	Article 13(4)
12	India	Article 13(4)
14	Ireland	Article 15(2)
15	Italy	Article 13(3)
16	Japan	Article 13(2)
18	Mexico	Article 13(4)
20	Norway	Article 13(5)
21	Philippines	Protocol (7)
22	Poland	Article 13(4)
24	Singapore	Article 13(4)
25	South Africa	Article 13(4)
26	Spain	Article 13(4)
27	Sweden	Article 12(a)(ii) and (b)(ii)
30	Turkey	Article 13(4)
31	United Kingdom	Part of Article 14(1), but only the following words "or from the alienation of shares in a company deriving their value or the greater part of their value directly or indirectly from such property"
32	Viet Nam	Article 13(4)

Article 10 – Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions

Notification of Existing Provisions in Listed Agreements

Not applicable

Article 11 – Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 11(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 11(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
4	Canada	Article 27(1) and (2)
21	Philippines	Article 1(2); Protocol (9)
16	Japan	Protocol (1)

Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 12(5) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 12(3)(a). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(8)(a)
2	Austria	Article 5(6)
3	Belgium	Article 5(6)
4	Canada	Article 5(8)(a)
5	Chile	Article 5(8)
6	Czech Republic	Article 5(6)
7	Denmark	Article 5(6)
8	Finland	Article 5(6)
9	French Republic	Article 5(6)
10	Germany	Article 5(5)
11	Hong Kong (China)	Article 5(8)(a)
12	India	Article 5(4)(a)
13	Indonesia	Article 5(5)(a)
14	Ireland	Article 5(6)
15	Italy	Article 5(5)
16	Japan	Article 5(8)(a)
17	Malaysia	Article 4(5)(a)
18	Mexico	Article 5(7)
19	Netherlands	Article 5(6)
20	Norway	Article 5(6)
21	Philippines	Article 5(4)
22	Poland	Article 5(7)
23	Russian Federation	Article 5(6)(a)
24	Singapore	Article 5(7)(a)
25	South Africa	Article 5(8)
26	Spain	Article 5(6)
27	Sweden	Article 4(5)(a)
28	Switzerland	Article 5(6)
29	Thailand	Article 5(8)(a)
30	Turkey	Article 5(7)
31	United Kingdom	Article 5(5)
32	Viet Nam	Article 5(8)(a)
33	China	Article 5(5)
34	Republic of Korea	Article 5(6)

Pursuant to Article 12(6) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 12(3)(b). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(9)
2	Austria	Article 5(7)
3	Belgium	Article 5(7)
4	Canada	Article 5(9)
5	Chile	Article 5(9)
6	Czech Republic	Article 5(7)
7	Denmark	Article 5(7)
8	Finland	Article 5(7)
9	French Republic	Article 5(7)
10	Germany	Article 5(6)
11	Hong Kong (China)	Article 5(9)
12	India	Article 5(5)
13	Indonesia	Article 5(6)
14	Ireland	Article 5(7)
15	Italy	Article 5(6)
16	Japan	Article 5(9)
17	Malaysia	Article 4(6)
18	Mexico	Article 5(8)
19	Netherlands	Article 5(7)
20	Norway	Article 5(7)
21	Philippines	Article 5(5)
22	Poland	Article 5(8)
23	Russian Federation	Article 5(7)
24	Singapore	Article 5(8)
25	South Africa	Article 5(9)
26	Spain	Article 5(7)
27	Sweden	Article 4(6)
28	Switzerland	Article 5(7)
29	Thailand	Article 5(9)
30	Turkey	Article 5(8)
31	United Kingdom	Article 5(6)
32	Viet Nam	Article 5(9)
33	China	Article 5(6)
34	Republic of Korea	Article 5(7)

Article 13 – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions

Notification of Choice of Optional Provisions

Pursuant to Article 13(7) of the Convention, New Zealand hereby chooses to apply Option A under Article 13(1).

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 13(7) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 13(5)(a). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(7)
2	Austria	Article 5(5)
3	Belgium	Article 5(4)
4	Canada	Article 5(7)
5	Chile	Article 5(7)
6	Czech Republic	Article 5(5)
7	Denmark	Article 5(4)
8	Finland	Article 5(4)
9	French Republic	Article 5(4)
10	Germany	Article 5(4)
11	Hong Kong (China)	Article 5(7)
12	India	Article 5(3)
13	Indonesia	Article 5(4)
14	Ireland	Article 5(5)
15	Italy	Article 5(3)
16	Japan	Article 5(7)
17	Malaysia	Article 4(3)
18	Mexico	Article 5(6)
19	Netherlands	Article 5(4)
20	Norway	Article 5(4)
21	Philippines	Article 5(3)
22	Poland	Article 5(6)
23	Russian Federation	Article 5(5)
24	Singapore	Article 5(6)
25	South Africa	Article 5(7)
26	Spain	Article 5(3)
27	Sweden	Article 4(3)
28	Switzerland	Article 5(4)
29	Thailand	Article 5(7)
30	Turkey	Article 5(6)
31	United Kingdom	Article 5(4)
32	Viet Nam	Article 5(7)
33	China	Article 5(4)
34	Republic of Korea	Article 5(4)

Article 14 – Splitting-up of Contracts

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 14(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 14(2) that is not subject to a reservation under Article 14(3)(b). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 5(6)
2	Austria	Protocol (2)
4	Canada	Article 5(6)
5	Chile	Article 5(6)
11	Hong Kong (China)	Article 5(6)
13	Indonesia	Protocol (With reference to Article 5)(b), second sentence and third sentence
16	Japan	Article 5(6)
18	Mexico	Article 5(5)
20	Norway	Article 22(2)
22	Poland	Article 5(5)
23	Russian Federation	Protocol (2)
24	Singapore	Article 5(5)
25	South Africa	Article 5(6)
26	Spain	Article 5(5)
29	Thailand	Article 5(6)
30	Turkey	Protocol (2)
32	Viet Nam	Article 5(6)
33	China	Article 5(3)(c)(ii)

Article 16 – Mutual Agreement Procedure

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 16(6)(a) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 16(4)(a)(i). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 25(1), first sentence
2	Austria	Article 24(1), first sentence
3	Belgium	Article 24(1), first sentence
4	Canada	Article 23(1), first sentence
5	Chile	Article 24(1), first sentence
6	Czech Republic	Article 22(1), first sentence
7	Denmark	Article 23(1), first sentence
8	Finland	Article 24(1), first sentence
9	French Republic	Article 24(1), first sentence
10	Germany	Article 24(1), first sentence
11	Hong Kong (China)	Article 23(1), first sentence
12	India	Article 25(1), first sentence
13	Indonesia	Article 24(1), first sentence
14	Ireland	Article 26(1), first sentence
15	Italy	Article 24(1), first sentence
16	Japan	Article 26(1), first sentence
17	Malaysia	Article 21(1), first sentence
18	Mexico	Article 23(1), first sentence
19	Netherlands	Article 23(1), first sentence
20	Norway	Article 25(1), first sentence
21	Philippines	Article 24(1), first sentence
22	Poland	Article 23(1), first sentence
23	Russian Federation	Article 24(1), first sentence
24	Singapore	Article 22(1), first sentence
25	South Africa	Article 23(1), first sentence
26	Spain	Article 23(1), first sentence
27	Sweden	Article 25(1), first sentence
28	Switzerland	Article 23(1), first sentence
29	Thailand	Article 25(1), first sentence
30	Turkey	Article 24(1), first sentence
31	United Kingdom	Article 24(1)
32	Viet Nam	Article 24(1), first sentence
33	China	Article 25(1), first sentence
34	Republic of Korea	Article 24(1), first sentence

Pursuant to Article 16(6)(b)(i) of the Convention, New Zealand considers that the following agreements contain a provision that provides that a case referred to in the first sentence of Article 16(1) must be presented within a specific time period that is shorter than three years from the first

notification of the action resulting in taxation not in accordance with the provisions of the Covered Tax Agreement. The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
13	Indonesia	Article 24(1), second sentence
15	Italy	Article 24(1), second sentence
21	Philippines	Article 24(1), second sentence

Pursuant to Article 16(6)(b)(ii) of the Convention, New Zealand considers that the following agreements contain a provision that provides that a case referred to in the first sentence of Article 16(1) must be presented within a specific time period that is at least three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Covered Tax Agreement. The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 25(1), second sentence
2	Austria	Article 24(1), second sentence
3	Belgium	Article 24(1), second sentence
4	Canada	Article 23(1), second sentence
5	Chile	Article 24(1), second sentence
6	Czech Republic	Article 22(1), second sentence
7	Denmark	Article 23(1), second sentence
8	Finland	Article 24(1), second sentence
9	French Republic	Article 24(1), second sentence
11	Hong Kong (China)	Article 23(1), second sentence
12	India	Article 25(1), second sentence
14	Ireland	Article 26(1), second sentence
16	Japan	Article 26(1), second sentence
18	Mexico	Article 23(1), second sentence
19	Netherlands	Article 23(1), second sentence
20	Norway	Article 25(1), second sentence
22	Poland	Article 23(1), second sentence
23	Russian Federation	Article 24(1), second sentence
24	Singapore	Article 22(1), second sentence
25	South Africa	Article 23(1), second sentence
26	Spain	Article 23(1), second sentence
28	Switzerland	Article 23(1), second sentence
29	Thailand	Article 25(1), second sentence
30	Turkey	Article 24(1), second sentence
32	Viet Nam	Article 24(1), second sentence
33	China	Article 25(1), second sentence
34	Republic of Korea	Article 24(1), second sentence

Notification of Listed Agreements Not Containing Existing Provisions

Pursuant to Article 16(6)(c)(i) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(b)(i).

Listed Agreement Number	Other Contracting Jurisdiction
18	Mexico
27	Sweden

Pursuant to Article 16(6)(c)(ii) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(b)(ii).

Listed Agreement Number	Other Contracting Jurisdiction
5	Chile
7	Denmark
10	Germany
13	Indonesia
14	Ireland
17	Malaysia
18	Mexico
21	Philippines
27	Sweden
28	Switzerland
31	United Kingdom

Pursuant to Article 16(6)(d)(i) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(c)(i).

Listed Agreement Number	Other Contracting Jurisdiction
9	French Republic
27	Sweden

Pursuant to Article 16(6)(d)(ii) of the Convention, New Zealand considers that the following agreements do not contain a provision described in Article 16(4)(c)(ii).

Listed Agreement Number	Other Contracting Jurisdiction
3	Belgium
5	Chile
6	Czech Republic
10	Germany
11	Hong Kong
15	Italy
22	Poland
23	Russian Federation
24	Singapore
25	South Africa
27	Sweden
29	Thailand
31	United Kingdom

Article 17 – Corresponding Adjustments

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 17(4) of the Convention, New Zealand considers that the following agreements contain a provision described in Article 17(2). The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 9(3)
2	Austria	Article 9(2)
3	Belgium	Article 9(2) (after amendment by Article 4 of (a))
4	Canada	Article 9(2)
5	Chile	Article 9(2)
6	Czech Republic	Article 9(2)
7	Denmark	Article 9(2)
11	Hong Kong (China)	Article 9(2)
12	India	Article 9(2) and (3)
14	Ireland	Article 11(2)
16	Japan	Article 9(2)
18	Mexico	Article 9(2)
19	Netherlands	Article 9(2)
21	Philippines	Article 9(2)
22	Poland	Article 9(2)
23	Russian Federation	Article 9(2)
24	Singapore	Article 9(2)
26	Spain	Article 9(2)
29	Thailand	Article 9(3)
30	Turkey	Article 9(2)
31	United Kingdom	Article 22(4)
32	Viet Nam	Article 9(2)
33	China	Article 9(2)

Article 18 – Choice to Apply Part VI

Notification of Choice of Optional Provisions

Pursuant to Article 18 of the Convention, New Zealand hereby chooses to apply Part VI.

Article 19 – Mandatory Binding Arbitration

Reservation

Pursuant to Article 19(12) of the Convention, New Zealand reserves the right for the following rules to apply with respect to its Covered Tax Agreements notwithstanding the other provisions of Article 19:

a) any unresolved issue arising from a mutual agreement procedure case otherwise within the scope of the arbitration process provided for by the Convention shall not be submitted to arbitration, if a decision on this issue has already been rendered by a court or administrative tribunal of either Contracting Jurisdiction;

b) if, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities of the Contracting Jurisdictions, a decision concerning the issue is rendered by a court or administrative tribunal of one of the Contracting Jurisdictions, the arbitration process shall terminate.

Article 23 – Type of Arbitration Process

Reservation

Pursuant to Article 23(7) of the Convention, New Zealand reserves the right for Part VI not to apply with respect to all Covered Tax Agreements for which the other Contracting Jurisdiction makes a reservation pursuant to Article 23(6).

Notification of Choice of Optional Provisions

Pursuant to Article 23(4) of the Convention, New Zealand hereby chooses to apply Article 23(5).

Article 24 – Agreement on a Different Resolution

Notification of Choice of Optional Provisions

Pursuant to Article 24(1) of the Convention, New Zealand hereby chooses to apply Article 24(2).

Reservation

Pursuant to Article 24(3) of the Convention, New Zealand reserves the right for Article 24(2) to apply only with respect to its Covered Tax Agreements for which Article 23(2) applies.

Article 26 – Compatibility

Reservation

Not applicable

Notification of Existing Provisions in Listed Agreements

Pursuant to Article 26(1) of the Convention, New Zealand considers that the following agreements are not within the scope of a reservation under Article 26(4) and contain a provision that provide for arbitration of unresolved issues arising from a mutual agreement procedure case. The article and paragraph number of each such provision is identified below.

Listed Agreement Number	Other Contracting Jurisdiction	Provision
1	Australia	Article 25(6) and (7)
16	Japan	Article 26(5);Protocol (16)

Article 28 – Reservations

Reservation Formulated for Scope of Arbitration

Pursuant to Article 28(2)(a) of the Convention, New Zealand formulates the following reservation with respect to the scope of cases that shall be eligible for arbitration under the provisions of Part VI.

1. New Zealand reserves the right to exclude a case presented under the mutual agreement procedure article of its Covered Tax Agreements from the scope of Part VI (Arbitration) to the extent that any unresolved issue involves the application of New Zealand's general anti-avoidance rule contained in section BG 1 of the Income Tax Act 2007.

NATIONAL INTEREST ANALYSIS:
Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Executive summary

1. On [__________] in [_________], New Zealand signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI).

2. The MLI is a multilateral international treaty that proposes to quickly and efficiently amend a significant number of double tax agreements (DTAs) around the world to take into account new treaty standards relating to treaty abuse and dispute resolution. The MLI cannot in and of itself allocate taxing rights between two jurisdictions; it is effective by modifying pre-existing DTAs. For it to modify a particular DTA, both jurisdictions must be parties to the MLI and must have included the DTA in their lists of notifications and reservations provided at the same time their instruments of ratification are deposited.

3. The negotiation of, and giving of effect to, DTAs (and the MLI) is provided for by section BH 1 of the Income Tax Act 2007.

4. DTAs are bilateral international treaties that are principally designed to encourage growth in economic ties between countries. They do this by reducing tax impediments to cross-border services, trade and investment. New Zealand has 40 DTAs in force, primarily with New Zealand’s major trading and investment partners.

5. While DTAs are beneficial for taxpayers, investors and governments themselves, there is the potential for these bilateral agreements to be misused to reduce or eliminate a multinational’s worldwide tax. Misuse of DTAs in this way has been a feature of a number of cross-border tax avoidance arrangements.

6. The misuse of DTAs forms part of a wider problem referred to as base erosion and profit shifting (BEPS), which has been the focus of significant global media and political attention since late 2012, following evidence suggesting that some multinationals pay little or no tax anywhere in the world.

7. BEPS is a global problem as many BEPS strategies exploit technical differences between different countries’ tax rules, so New Zealand has been working with the Organisation for Economic Co-operation and Development (OECD) and G20 to develop a co-ordinated global solution to address BEPS through the 15-point OECD/G20 BEPS Action Plan.

8. A number of the items on the BEPS Action Plan address the misuse of DTAs and can only be implemented through changes to DTAs themselves. Some of these solutions are “minimum standards” that countries that commit to solving BEPS are expected to adopt.

Other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following adoption of the OECD/G20 BEPS Action Plan.

9. Countries, including New Zealand, were presented with the difficulty of how to quickly and efficiently implement these measures without requiring the bilateral renegotiation of several thousand existing DTAs, which could take several years (or even potentially decades). For this reason, the Multilateral Instrument was developed under Action 15 of the OECD/G20 BEPS Action Plan to swiftly amend the DTAs of all participating jurisdictions.

10. To make the best use of the MLI, New Zealand's strategy has been to include the majority of its DTAs within the scope of the MLI and has chosen to adopt as many of the MLI provisions as possible, as they are in line with New Zealand's overall treaty policy. This gives New Zealand the best chance of strengthening its DTAs with as many jurisdictions as possible.

Nature and timing of the proposed treaty action

11. New Zealand signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI) on [____] in [____]. The text of the Multilateral Instrument is attached as Annex A.

12. The proposed treaty action is to ratify the Multilateral Instrument into force by depositing New Zealand's instrument of ratification with the Depositary of the Multilateral Instrument, the Secretary-General of the OECD, in accordance with Articles 27 and 34 of the Multilateral Instrument, after the necessary domestic procedures for entry into force have been completed. At the same time New Zealand's instrument of ratification is deposited, New Zealand must also provide its list of confirmed notifications and reservations. This is attached as Annex B.

13. Before ratification can occur, the MLI must undergo Parliamentary treaty examination, in accordance with Parliament's Standing Order 397, and must successfully be given the force of law in New Zealand by an Order in Council made pursuant to section BH 1 of the Income Tax Act 2007.

14. In general, the MLI will enter into force for New Zealand on the first day of the month following the expiration of a period of three calendar months after the date New Zealand's instrument of ratification is deposited. However, the MLI itself will only enter into force once five jurisdictions have deposited their instruments of ratification. The procedure for entry into force of the MLI is set out in Article 34 of the MLI.

15. The MLI cannot in and of itself allocate taxing rights between two jurisdictions; it is effective by modifying pre-existing DTAs. As DTAs are bilateral agreements negotiated by two jurisdictions, Article 35 of the MLI provides that the provisions of the MLI will only have effect in relation to a particular DTA once the MLI has entered into force for both parties to that DTA where both jurisdictions have nominated the DTA to be covered by the MLI by

including the DTA in their list of confirmed notifications and reservations submitted at the time the instrument of ratification is deposited (i.e. it is a covered tax agreement).

16. As with New Zealand's DTAs more generally, Zealand's signature of the Multilateral Instrument does not extend to Tokelau.

Reasons for New Zealand becoming party to the treaty

General reasons for New Zealand concluding double tax agreements

17. New Zealand began entering into DTAs in 1947, and currently has a network of 40 DTAs in force, predominantly with New Zealand's main trading and investment partners.

18. DTAs are bilateral international treaties that are principally designed to encourage growth in economic ties between countries. DTAs do this by reducing tax impediments to cross-border services, trade and investment. Some impediments to cross-border economic activity can be addressed unilaterally. For example, New Zealand generally relieves double taxation by unilaterally allowing tax residents who derive foreign-sourced income to credit foreign tax paid against their New Zealand tax liability. New Zealand also unilaterally reduces withholding taxes on certain forms of inbound investment. However, unilateral solutions cannot address all of the issues that arise from cross-border activity. Moreover, the country applying unilateral measures must then bear the full cost of the relief. DTAs address these problems by facilitating bilateral solutions. DTAs enable a wider range of issues to be addressed than is possible unilaterally, and also enable the parties to a DTA to share the cost of providing relief.

19. DTA networks make an important contribution to the expansion of world trade and to the development of the world economy, which are key objectives of the OECD. Internationally, the OECD has therefore assumed a leading role in promoting the use of DTAs. In particular, the OECD has produced a Model Tax Convention, and a comprehensive commentary, for member and non-member countries to use as a basis for concluding DTAs. As a member of the OECD, New Zealand is subject to an express recommendation issued by the OECD Council in 1997[1] for all member countries:

1. to pursue their efforts to conclude bilateral tax conventions … with those member countries, and where appropriate with non-member countries, with which they have not yet entered into such conventions …

2. when concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention, as interpreted by the Commentaries thereon.

20. New Zealand's negotiating model is based on the OECD Model Tax Convention, with some differences that take into account New Zealand's status as a small capital importing

[1] The recommendation follows similar OECD Council recommendations that have been in place since before New Zealand joined the OECD.

nation and other unique features of New Zealand's economy, for example, the importance of primary industries. Therefore, the OECD Model Tax Convention and its associated commentary play an important role in New Zealand's overall treaty policy and New Zealand's DTA network.

Reasons for New Zealand becoming party to the Multilateral Instrument

21. While DTAs are beneficial for taxpayers, investors and governments, there is the potential for these bilateral agreements to be misused to reduce or eliminate a multinational's worldwide tax. Misuse of DTAs in this way has been a feature of a number of cross-border tax avoidance arrangements.

22. The misuse of DTAs forms part of a wider problem referred to as base erosion and profit shifting (BEPS), which has been the focus of significant global media and political attention since late 2012, following evidence suggesting that some multinationals pay little or no tax anywhere in the world.

23. BEPS is a global problem as many BEPS strategies exploit technical differences between different countries' tax rules, and New Zealand has been working with the OECD and G20 to develop a co-ordinated global solution to address BEPS through the 15-point OECD/G20 BEPS Action Plan. The New Zealand Government has confirmed its commitment to resolving BEPS on a number of occasions.[2]

24. A number of the items on the OECD/G20 BEPS Action Plan address the misuse of DTAs and can only be implemented through changes to DTAs themselves. These are:

- preventing the granting of treaty benefits in inappropriate circumstances (Action 6);
- preventing the artificial avoidance of permanent establishment status (Action 7);
- neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2); and
- providing improved mechanisms for effective dispute resolution (Action 14).

25. Some of the solutions under these Action items are "minimum standards" that countries that commit to solving BEPS are expected to adopt. Other provisions are optional, but are DTA "best practice" and now form part of the OECD Model Tax Convention following the adoption of the OECD/G20 BEPS Action Plan.

26. Given the important role the OECD Model Tax Convention plays in informing New Zealand's treaty policy, as well as New Zealand's commitment to resolving BEPS more generally, New Zealand is committed to including these minimum standards as well as the

[2] See for example, the BEPS Cabinet Paper released in June 2016 http://taxpolicy.ird.govt.nz/sites/default/files/2016-other-cabinet-paper-beps-update.pdf and the Government press release welcoming the release of the Multilateral Instrument on 28 November 2016 https://www.beehive.govt.nz/release/oecd-multilateral-instrument-counter-beps.

optional best practice provisions in its DTAs, where they are in line with overall New Zealand treaty policy.

27. New Zealand's treaty negotiation resources are limited and to update New Zealand's entire DTA network would take several years, if not decades, particularly as many of New Zealand's treaty partners would likely place greater importance on updating more significant treaties. This would limit New Zealand's ability to meet the OECD minimum standard in a timely fashion.

28. Finding resources to update DTAs is a common problem faced by many countries, not just New Zealand. The development of the Multilateral Instrument under Action 15 of the OECD/G20 BEPS Action Plan takes into account the existence of several thousand DTAs around the world and allows participating jurisdictions to quickly and efficiently amend their DTAs to counter BEPS. The text of the MLI was developed by the OECD Ad Hoc Group consisting of officials from more than 100 participating jurisdictions including New Zealand and was formally adopted by the OECD in November 2016.

29. The MLI is flexible and allows countries to choose:

- which of their existing DTAs they wish to modify through the MLI;
- alternative ways of meeting BEPS minimum standards on treaty abuse and dispute resolution; and
- whether they want to adopt the OECD-recommended provisions for non-minimum standards. Within some of these provisions, there are alternative ways of addressing BEPS concerns and the ability for countries to enter a variety of reservations.

30. To make the best use of the MLI, New Zealand's strategy has been to include the majority of its DTAs within the scope of the Multilateral Instrument and has chosen to adopt as many of the MLI provisions as possible. This gives New Zealand the best chance of strengthening its DTAs with as many jurisdictions as possible.

31. New Zealand's list of notifications and reservations can be found in Annex B. This document lists the DTAs New Zealand wishes to be covered by the MLI and the provisions New Zealand has indicated it will adopt. This document must be submitted at the time instrument of ratification is deposited and will be considered "confirmed" at that point in time. There is limited ability to amend New Zealand's notifications and reservations following entry into force, which is discussed in further detail the section titled *Subsequent protocols and/or amendments to the treaty and their likely effects.*

32. Of New Zealand's 40 in-force DTAs, New Zealand has nominated 34 to be covered by the MLI. Many of these DTAs were concluded in the 1970s and 1980s and do not reflect modern treaty standards, even before the work on BEPS was completed. The six DTAs that have not been listed are with jurisdictions who will not be signing the MLI. To be modified by the MLI, both New Zealand and the other jurisdiction must elect for the MLI to apply to the DTA (if there is a match, then the DTA is a "covered tax agreement"). Based on current

draft notifications, New Zealand is expected to have 28 covered tax agreements. See Annex C. While this list is not final, it provides a fairly good indication of the likely coverage of the MLI. Final coverage will not be confirmed until each jurisdiction deposits its instrument of ratification with the OECD Depositary.

33. As noted above, New Zealand's strategy in formulating its notifications and reservations has been to adopt as many of the MLI provisions as possible. This is because they are base protection measures that are in line with New Zealand's existing treaty policy (which has a greater source state emphasis than the OECD Model Tax Convention) or are taxpayer friendly measures that provide improved access to dispute resolution. For example, New Zealand generally takes a broader approach in its DTAs than the current OECD Model Tax Convention in determining whether a permanent establishment exists. This means that the recommendations under Action 7 (preventing the artificial avoidance of permanent establishment status) of the OECD/G20 BEPS Action Plan which are contained in Articles 12 to 15 of the MLI are not contrary to New Zealand's general treaty policy and, in New Zealand's view, represent an improvement to the OECD Model Tax Convention.

34. The optional provisions New Zealand has chosen cover the following issues:

- Fiscally transparent entities (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The provision in Article 3 clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident.
- Dual resident entities can be used to take advantage of arbitrage opportunities by manipulating the current "place of effective management" test. The proposed provision in Article 4 will require competent authorities to agree the residence status of a dual resident entity. If there is no agreement, then treaty benefits will be denied, or only granted to the extent to which the competent authorities can agree.
- In the OECD Model Tax Convention – and in many of New Zealand's modern treaties – a lower withholding tax rate is available where the shareholder owns more than a certain proportion of the company's shares. The MLI provision in Article 8 requires shares to be held for a minimum of 365 days for the shareholder to be entitled to reduced withholding tax rates on dividends. This prevents shareholders buying shares and holding them temporarily in order to access lower withholding rates.
- Investors can hold land through companies and dispose of the shares in the company to avoid paying tax on the disposal of that land. Many treaties contain a "land-rich company rule" which allows the source jurisdiction to tax income derived from land when the majority of a company's assets consist of land. To prevent the artificial and temporary dilution of the amount of land held by a company just before sale, the provision in Article 9 requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares and extends the rule to interests in other entities such as partnerships and trusts.

- Permanent establishments can be established in third states to exploit low tax rates and branch exemptions. Article 10 of the MLI introduces a provision that denies treaty benefits in the case of income derived by a permanent establishment of an enterprise resident in one of the parties to the DTA, where that permanent establishment is situated in a low tax third state and the residence state exempts the permanent establishment's income.
- Article 11 introduces a provision that preserves a jurisdiction's right to tax its own residents. For example, this provision would prevent a New Zealand resident who is engaged in a tax avoidance arrangement from claiming that a DTA prevents New Zealand from using its domestic general anti-avoidance rule to impose tax.
- A source jurisdiction generally cannot tax the business profits of a resident of the other contracting state unless there is a permanent establishment in the source state. The provisions in Articles 12 to 15 of the MLI introduce changes to counter common strategies used to avoid permanent establishment status.

35. In addition to addressing these specific BEPS concerns, Article 6 of the MLI proposes to amend the preamble to DTAs to confirm that they are not intended to be used to generate double non-taxation. Under Article 7, New Zealand has selected the option of adding a principal purpose test to its DTAs. The principal purpose test is a general anti-abuse rule that applies to the whole DTA. Both Articles 6 and 7 form part of the OECD minimum standard.

36. In addition to these base protection measures, New Zealand is signing up to taxpayer friendly measures relating to the mutual agreement procedure (MAP) and the availability of arbitration as a form of dispute resolution. These measures are a result of the work on Action 14 of the OECD/G20 BEPS Action Plan relating to improving mechanisms for effective dispute resolution. They recognise the fact that measures to counter BEPS should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues.

37. Article 16 of the MLI introduces a provision allowing taxpayers to approach the competent authorities of either party to the DTA to request MAP where they believe taxation is not in accordance with the treaty. This is a new OECD minimum standard. While the majority of New Zealand's DTAs contain MAP provisions, the MLI will amend these provisions to allow taxpayers to approach the competent authority of either jurisdiction (currently they only permit a case to be presented to the competent authority of the taxpayer's country of residence). In addition, Article 16 creates a new minimum standard regarding time limits for bringing a case to MAP and for implementing a solution.

38. Article 17 requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. This provision is already found in most of New Zealand's DTAs except for New Zealand's oldest treaties, which were concluded before the OECD Model Tax Convention included such a provision.

39. New Zealand has also opted to apply Part VI of the MLI, which will introduce arbitration as a means of dispute resolution. If a solution cannot be reached under MAP, taxpayers have the ability to request that unresolved issues can be taken to arbitration. New Zealand has already agreed to arbitration in two of its treaties (with Australia and Japan). New Zealand’s experience is that the arbitration facility is very rarely used, but it acts as an incentive for the competent authorities of two jurisdictions to come to an agreement within the required time period for MAP.

40. Note that while New Zealand has indicated that it will sign up to many of the optional provisions, these will only apply to a DTA if New Zealand’s treaty partner also signs the MLI, includes their DTA with New Zealand in their list of notifications and reservations and chooses to apply the same option as New Zealand.

Advantages and disadvantages to New Zealand of the Multilateral Instrument entering into force and not entering into force for New Zealand

41. The standard process for making amendments to DTAs is to renegotiate a new agreement or to negotiate a protocol that amends specific parts of the existing DTA (an amending protocol). In absence of the MLI, New Zealand would be expected to enter into bilateral negotiations with each of its treaty partners in order to meet the new OECD minimum standard. The advantages and disadvantages of bringing the MLI into force are therefore considered in relation to the status quo and also in relation to this bilateral negotiation approach.

42. The MLI is a novel approach to modifying DTAs, but it is not unprecedented in international law. Experts in both international tax and public international law participated in the OECD Ad Hoc Group that developed the MLI to ensure that it works as intended.

43. The provisions in the MLI have been drafted more broadly than they otherwise would for an amending protocol to take account of the fact that the MLI must be able to apply to not one DTA, but several thousand. This, combined with a limited ability to customise the MLI’s provisions, means that the interaction between the MLI and DTAs is not as straightforward as an amending protocol.

44. This complication is one of the most significant trade-offs, but despite this, ratifying the MLI is expected to be in New Zealand’s overall interests.

Advantages of the Multilateral Instrument entering into force for New Zealand

45. The main advantage in the MLI entering into force for New Zealand is that it would reduce the ability of multinationals and other investors to misuse DTAs to reduce both their New Zealand tax and their worldwide tax, or in other words, it resolves BEPS issues that relate to tax treaties. This is achieved through changes to specific provisions found in DTAs,

as well as through more general changes, such as a new preamble and the introduction of a general treaty anti-abuse rule.

46. Many of New Zealand's treaties already contain pre-cursors to some of the MLI provisions, which will also feature in the updated OECD Model Tax Convention (for example, a principal purpose test, or a land-rich company rule that extends to interests in other entities). However, the drafting of these provisions often differs from treaty to treaty with no or little OECD commentary to rely on. By signing up to the relevant MLI provisions and replacing existing provisions, New Zealand will have consistency across its treaty network and will also be able to rely on the new OECD commentary relating to those provisions.

47. While the resolution of treaty-related BEPS issues and the introduction of improved mechanisms for dispute resolution could also occur in absence of the MLI, in order to do this New Zealand would be required to enter into bilateral negotiations with each of its treaty partners.

48. The main advantage of the MLI compared with the bilateral negotiation approach is that the MLI process is much faster and more efficient. Based on current projections it is possible that the MLI could enter into effect for New Zealand in 2019. Bilateral negotiations, on the other hand, could take several years or potentially decades to complete. No additional negotiations or discussions with treaty partners are required for the MLI to apply to a DTA. This is because jurisdictions have been required to provide draft notifications and reservations at various stages of the MLI project, which has provided clarity as to jurisdictions' positions. In addition, "speed matching" sessions were arranged by the OECD in late February – early March 2017 so that bilateral treaty partners could meet to discuss any issues with the application or implementation of the MLI, either in general or with regard to specific provisions.

49. In addition to the time it would take to complete bilateral negotiations, each individual amending protocol would need to be ratified according to each jurisdiction's domestic law requirements, as opposed to ratifying the single MLI. This could add further time to the process and create bottlenecks in parliamentary processes, as other jurisdictions may place greater importance on ratifying amending protocols with more significant economies than New Zealand.

50. In this respect, the main advantages of the MLI compared with entering into individual bilateral negotiations are that the BEPS solutions will be incorporated into New Zealand's DTAs as soon as possible and resources (from both a policy perspective and a Parliamentary perspective) will be freed up to work on other priorities.

51. New Zealand's tax system operates on the principle of voluntary compliance, which relies on taxpayers understanding their tax obligations and how the wider tax system works. An important part of this is that, overall, the tax system is seen to be fair. If the view persists that multinationals do not pay their fair share of tax, this could undermine the integrity of the

tax system. Therefore, New Zealand's ratification of the MLI and the resolution of treaty-related BEPS issues in a timely manner support the overall integrity of the New Zealand tax system. This is discussed in further detail in the section titled *Economic, social, cultural and environmental costs and effects of the treaty action.*

52. The advantages to New Zealand in becoming a party to the MLI (as compared to the bilateral negotiation approach) can therefore be summarised as follows:

- it significantly reduces the possibility of New Zealand's DTAs being misused to reduce or eliminate tax liabilities;
- it introduces taxpayer friendly measures relating to disputes resolution;
- it allows New Zealand to update the majority of its DTAs quickly and efficiently;
- the timely resolution of treaty related BEPS issues supports the overall integrity of the New Zealand tax system.

Disadvantages of the Multilateral Instrument entering into force for New Zealand

53. The main disadvantage of the MLI entering into force for New Zealand stems from the fact that the provisions in the MLI have been drafted more broadly than they otherwise would for an amending protocol to take account of the fact that the MLI must be able to apply to not one DTA, but several thousand.

54. This means that there can be some ambiguity in how the MLI applies to a particular DTA. This ambiguity is mitigated in many cases as a given MLI provision will only replace the corresponding DTA provision if both treaty partners notify the same provision.

55. Any residual ambiguity may give rise to compliance costs as taxpayers will need to consider the DTA alongside the text of the MLI and the confirmed notifications and reservations of both parties to the DTA. This would not occur if instead of ratifying the MLI, New Zealand into individual bilateral amending protocols with each of its DTA partners.

56. There are ways in which these upfront compliance costs may be mitigated. Publishers may produce consolidated texts as they currently do with amending protocols and original DTAs. In addition to this, New Zealand Inland Revenue officials are continuing discussions with overseas counterparts to determine what additional certainty the competent authorities may be able to provide (for example, through the mutual agreement procedure in DTAs, competent authorities can produce a memorandum of understanding to resolve any difficulties or doubts arising as to the interpretation or application of the MLI with respect to a specific DTA). New Zealand officials may also consider producing informal consolidated versions of New Zealand's DTAs in response to submissions requesting this.

57. This complication is one of the most significant trade-offs, but despite this, bringing the MLI into force is expected to be in New Zealand's overall interests. Any upfront compliance costs associated with determining how the MLI modifies a particular DTA and

the administrative costs associated with producing guidance on the application of the MLI would be offset by the savings made from not having to enter into bilateral negotiations with each DTA partner and then having to bring each amending protocol into force.

58. There are also compliance and administrative costs that would still arise if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTAs partners, for example in the context of competent authority agreements to determine the residence of dual resident entities or in challenge the application of specific anti-avoidance provisions.

59. The issue of compliance and administrative costs is discussed in further detail in the section titled *The costs to New Zealand of compliance with the treaty.* While we are unable to quantify these compliance and administrative costs, we expect them to be modest and through consultation officials are working on ways to minimise these further.

60. Another disadvantage is the uncertainty of outcomes for each individual DTA. Note that while New Zealand has indicated that it will sign up to many of the optional provisions, these will only apply to a DTA if New Zealand's treaty partner also signs the MLI, includes their DTA with New Zealand in their list of notifications and reservations and chooses to apply the same option as New Zealand. As stated, notifications and reservations are considered to be in draft form until the instrument of ratification is deposited. Therefore, the modifications to a specific DTA will not be completely certain until both parties have completed their domestic procedures for entry into force and deposited their instruments of ratification. Notwithstanding this uncertainty, New Zealand can control its own position and only choose provisions that it believes are principled and will enhance New Zealand's DTA network. If countries choose to sign up to fewer MLI provisions than New Zealand, then the DTA will still be strengthened to the extent there is a match. New Zealand believes the provisions in the MLI are principled improvements on the current OECD Model Tax Convention and therefore supports the inclusion of the provisions in its treaties so far as it is possible.

61. Some stakeholders have raised issues about the inability to consider a set and certain package of measures on a treaty-by-treaty basis (as DTAs are usually a negotiated package, tailored to the specific circumstances of the jurisdictions involved and their bilateral relationship). For example, they have suggested it may be ideal to combine the new strengthened permanent establishment rules or the principal purpose test with the counterbalancing taxpayer-friendly measure of binding arbitration.

62. Some countries may choose only to adopt the former provisions and not the latter, particularly as the inclusion of a principal purpose test is one way of meeting the minimum standard on treaty abuse under Article 7, while arbitration is optional. Theoretically it would be possible to exclude from the scope of the MLI DTAs with jurisdictions who have indicated in their draft notifications that they will not be signing up to arbitration. However, this would reduce the efficacy of the MLI in enabling New Zealand to meet the OECD minimum standard as New Zealand would have to endeavour to undertake bilateral negotiations with

these excluded jurisdictions, which could represent about half of New Zealand's DTAs, based on current draft notifications. This is undesirable for the reasons outlined above. It would also mean that – until bilateral negotiations can take place – the DTAs excluded on this basis would remain vulnerable to the BEPS techniques the MLI is designed to address. On balance it is in New Zealand's interest to obtain the stronger DTA provisions, even if it is without the optional arbitration provisions. We also note that many of New Zealand's DTAs already include a principal purpose test and broader permanent establishment rules, but no ability to pursue arbitration. Therefore this combination is already a feature of some of our existing DTAs and, from New Zealand's perspective, is not problematic.

63. Some of the provisions in the MLI (for example, the dual resident entity provision) require taxpayer engagement with competent authorities to determine their tax position. This will increase compliance and administrative costs in these cases. These provisions are used sparingly and are generally confined to areas where tax avoidance arrangements have been prevalent. However, there will be a need to put in place administrative measures to increase taxpayer certainty and minimise compliance costs as much as possible, particularly in bona fide cases where there is no mischief. Eight of New Zealand's DTAs already contain this provision and it has not, to our knowledge, been problematic. In addition, if instead of ratifying the MLI, New Zealand entered into individual bilateral amending protocols, these costs would still arise. This is discussed in the section titled *The costs to New Zealand of compliance with the treaty*.

64. As New Zealand is signing up to the optional arbitration provisions contained in Part VI of the MLI, costs will be incurred if a case is submitted for arbitration. However, as noted below in the section titled *The costs to New Zealand of compliance with the treaty*, the actual costs associated with administering the arbitration provisions are likely to be negligible as New Zealand's experience is that arbitration is very rarely used and would still arise if New Zealand agreed to include arbitration in its DTAs in individual bilateral amending protocols.

Advantages of the Multilateral Instrument not entering into force for New Zealand

65. It is an option not to ratify the MLI. In that case, the disadvantages identified above relating to implementation would not arise.

66. In the fullness of time, New Zealand would be able to negotiate amending protocols with each of its DTA partners and tailor the drafting of these protocols to suit the preferences and needs of the treaty partners. This would make it clearer to taxpayers, practitioners and tax authorities what the exact change to each DTA is.

67. In addition, the amending protocols would also be able to cover issues not included in the MLI.

Disadvantages of the Multilateral Instrument not entering into force for New Zealand

68. If New Zealand does not become a party to the MLI, there are two possible options.

69. The first is to leave New Zealand's DTAs as they are. This would mean that there would still be opportunities for New Zealand's DTAs to be misused to eliminate tax and New Zealand would not meet the new OECD minimum standard. As an OECD member country and a member of BEPS Inclusive Framework,[3] this position is undesirable.

70. The second and more realistic option, given that New Zealand has indicated its commitment to the BEPS project is for New Zealand to begin bilateral negotiations with each of its DTA partners to incorporate the BEPS recommendations into its existing DTAs.

71. Bilateral negotiations, however, could take several years or decades to complete. In comparison, no additional negotiations or discussions with treaty partners would be required for the MLI to apply to a DTA. This is because jurisdictions have been required to provide draft notifications and reservations at various stages of the MLI project, which has provided clarity as to jurisdictions' positions. In addition, "speed matching" sessions were arranged by the OECD in late February and early March 2017 so that bilateral treaty partners could meet to discuss any issues with the application or implementation of the MLI, either in general or with regard to specific provisions.

72. In addition to the time it would take to complete bilateral negotiations, each individual amending protocol would need to be brought into force according to each jurisdiction's domestic law requirements, as opposed to bringing into force the single MLI. This could add further time to the process and create bottlenecks in parliamentary processes, as other jurisdictions may place greater importance on ratifying amending protocols with more significant economies than New Zealand.

73. This is problematic for several reasons. It leaves New Zealand's DTAs open to misuse for a much longer period of time, but it also has the potential to undermine the integrity of the tax system if there is a continued perception that multinationals do not pay their fair of tax in New Zealand. This is discussed in further detail in the sections titled *Advantages of ratifying the Multilateral Instrument* and *Economic, social, cultural and environmental costs and effects of the treaty action.* It would also mean that resources that could otherwise be used to progress other projects and government priorities would be tied up in negotiating and ratifying individual bilateral protocols.

74. Therefore, not becoming party to the MLI, and entering into bilateral negotiations with all of New Zealand's treaty partners would not be in New Zealand's overall interests. Of the options available, the proposed treaty action is the best policy option and will achieve the Government's policy objectives.

[3] The Inclusive Framework is a group of over 90 jurisdictions that have committed to combatting BEPS. Members of the inclusive framework will develop a monitoring process for the four minimum standards as well as put in place the review mechanisms for other elements of the BEPS Package. One of the functions of the Inclusive Framework is to support the development of the toolkits for low-capacity developing countries.

Legal obligations which would be imposed on New Zealand by the treaty action, the position in respect of reservations to the treaty, and an outline of any dispute settlement mechanisms

75. DTAs cannot impose additional tax obligations beyond what is provided for under domestic law. This means that although the MLI consists largely of base protection measures that would allow the source country to impose tax where the existing DTA does not, these measures cannot go beyond what would otherwise be imposed in absence of a DTA.

76. The text of the MLI itself cannot be amended to suit each jurisdiction's preferences, but the MLI provides flexibility by allowing jurisdictions to opt into or reserve against certain provisions. The possible reservations are described in each Article and Article 28 provides that these are the only reservations that are able to be made. In the case of arbitration, free form reservations are permitted, but these must be accepted by the jurisdiction's treaty partner in order for the reservation to apply to a DTA.

77. To ensure the operation of the MLI is clear and transparent, signatories must notify the OECD Depositary of which DTAs they wish to cover, which reservations they wish to enter, optional provisions they wish to choose and which provisions in their nominated DTAs will be modified by the MLI. The OECD will publish this information online and it will be readily accessible to the public.

78. These reservations must either be made at the time of signature of the MLI and confirmed at the time the instrument of ratification is deposited, or a provisional list of expected reservations must be provided at the time of signature and subsequently confirmed at the time the instrument of ratification is deposited. At the time of signature, New Zealand provided a provisional list of expected reservations and so New Zealand's confirmed notifications and reservations must be submitted at the time the instrument of ratification is deposited.

79. After a jurisdiction's choices and reservations are confirmed at the time the instrument of ratification is deposited, that jurisdiction is still able to add new DTAs to their list of treaties covered by the MLI and withdraw their reservations (or reduce the scope of their reservations), but are unable to enter new or broader reservations. The effect of this is that, following ratification, New Zealand (and other) jurisdictions can expand, but not narrow, the application of the MLI to their DTA network. This is provided for in Articles 28 and 29 of the Multilateral Instrument.

80. New Zealand's provisional notifications and reservations can be found in Annex B and the overall effect of New Zealand's options and reservations is discussed in the section titled *Reasons for New Zealand becoming party to the treaty*. As noted in that section, the MLI provisions will only apply to a DTA if the other treaty partner also chooses the same option. This means that the effect of the MLI could vary from treaty to treaty.

81. There is no dispute settlement mechanism for the MLI itself, but Article 32 provides that any questions arising as to the interpretation or implementation of the MLI may be addressed by a "Conference of the Parties". Under Article 31 a Conference of the Parties can be convened to consider a proposed amendment at the request of one of the parties to the MLI, but only if one third of the parties to the MLI support the request within six calendar months of the request being communicated.

82. Note, however, that New Zealand is signing up to improved MAP provisions and arbitration, which will improve the dispute resolution mechanisms available in New Zealand's existing DTAs that are being amended by the MLI.

Measures which the Government could or should adopt to implement the treaty action, including specific reference to implementing legislation

83. Subject to the successful completion of the Parliamentary treaty examination process, the MLI will be incorporated into domestic legislation by Order in Council pursuant to section BH 1 of the Income Tax Act 2007. Section BH 1 provides for the giving of overriding effect to DTAs by Order in Council. However, the override relates only to tax matters, and applies only in respect of the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993.

84. The override of the Inland Revenue Acts is necessary to give effect to the core provisions of the MLI and New Zealand's DTAs, which may provide relief from tax that would otherwise be imposed under domestic law. The override of the Official Information Act 1982 is necessary to ensure that confidential communications with the other jurisdiction do not have to be disclosed. The override of the Privacy Act 1993 is necessary to ensure that information regarding natural persons can be exchanged according to the terms of the treaty.

85. Article 34 of the MLI provides that the agreement itself will only enter into force once five jurisdictions have completed their domestic law requirements and have deposited their instruments of ratification. In particular, it will enter into force on the first day of the month following the expiration of a period of three calendar months beginning on the date of deposit of the fifth instrument of ratification. If New Zealand is one of the first five jurisdictions to ratify the MLI, it will enter into force for New Zealand on that date. If not, the MLI will enter into force for New Zealand on the first day of the month following the expiration of a period of three calendar months after the date New Zealand's instrument of ratification is deposited.

86. New Zealand will be in a position to deposit its instrument of ratification with the Depositary of the MLI, the Secretary-General of the OECD, once the Order in Council has entered into force, which will be 28 days after its publication in the *New Zealand Gazette.*

87. As the MLI affects pre-existing DTAs that have been negotiated by two jurisdictions, Article 35 provides that the provisions of the MLI will only have effect in relation to a particular DTA once the MLI has entered into force for both parties to that DTA. For withholding tax, it will apply where the event giving rise to the tax occurs on or after 1

January of the next calendar year beginning on or after the latest date on which the MLI enters into force for each of the parties to the covered tax agreement. For income tax, it will apply to taxable periods (in New Zealand's case, income years) beginning on or after a 6 month period from the latest date on which the MLI enters into force for each of the parties to the covered tax agreement.

88. Some domestic law changes may be needed to facilitate the modifications to New Zealand's DTAs by the MLI. For example, officials anticipate there may need to be some amendments to the dispute procedures in Part 4A of the Tax Administration Act 1994 to enable cases to be submitted to arbitration without prejudicing taxpayer rights under the domestic law. There may also be changes needed to the time bar rules to allow arbitration decisions to be implemented notwithstanding domestic law time limits for amending assessments and providing taxpayer refunds.

89. As an alternative to the above Order in Council mechanism, the MLI could be given legislative effect by means of the enactment of a dedicated statute. However, this option would unnecessarily increase the amount of primary tax legislation and could be difficult to achieve in reality given the system for depositing notification and reservations, so it is not preferred or practical.

Economic, social, cultural and environmental costs and effects of the treaty action

90. With the political and media focus on BEPS in recent years, there has been a sentiment among the general public that multinationals are not paying their fair share of tax.

91. New Zealand's tax system operates on the principle of voluntary compliance, which relies on taxpayers understanding their tax obligations and how the wider tax system works. An important part of this is that, overall, the tax system is seen to be fair. If the view persists that multinationals do not pay their fair share of tax, this could undermine the integrity of the tax system and the ability to New Zealand to operate a tax system based on voluntary compliance and self-assessment.

92. The provisions that New Zealand is signing up to in the MLI are base protection measures which will strengthen New Zealand's ability to tax a multinational's income where there is a New Zealand source and will reduce the ability of multinationals to misuse those DTAs to eliminate tax in New Zealand.

93. Therefore, New Zealand's ratification of the MLI and the resolution of treaty-related BEPS issues in a timely manner will assist in supporting the overall integrity of the New Zealand tax system.

94. In addition, ratifying the MLI may enhance or reinforce New Zealand's reputation in the international community as a supporter of the OECD/G20 BEPS project.

95. From an economic impact perspective, the MLI, as a tool to resolve BEPS concerns that arise as a result of the misuse of DTAs, increases worldwide economic efficiency. This is because the use of BEPS techniques results in cross-border investments being subsidised relative to domestic investment. This leads to an inefficient allocation of investment internationally. Eliminating this misallocation would increase worldwide efficiency, leading to higher worldwide incomes.

96. One source of such inefficiency arises from the use of complex arrangements to benefit from certain provisions found in DTAs. The introduction of a whole-of-treaty anti-abuse rule (the principal purpose test in Article 7) through the MLI should have a dampening effect on taxpayers' appetites to use such complex arrangements.

97. However, there is a potential trade-off that should be noted - increasing the tax that New Zealand is able to impose under a DTA could have a negative impact on the level of foreign investment into New Zealand and on the cost of capital. This concern is not unique to the MLI and is a potential concern with any tax measure that increases the effective rate of tax on inbound investment. In June 2016, officials released a draft paper titled *New Zealand's taxation framework for inbound investment* which explores the issue in greater detail and can be found at www.taxpolicy.ird.govt.nz. In line with the analysis in this paper, our assessment is that any impact would likely be low and is acceptable in the overall context of the BEPS project. New Zealand is adopting the MLI alongside a number of likeminded countries who are implementing the BEPS measures broadly at the same time. Furthermore, the base protection measures included in the MLI are important to protect the New Zealand tax base and ensure that New Zealand is able to collect its fair share of revenues.

98. As stated in *New Zealand's taxation framework for inbound investment:*

"Taxes are necessary to fund government spending. New Zealand faces growing fiscal pressures with an ageing population. Maintaining robust tax bases is important to reduce upward pressures on tax rates and help maintain our coherent tax structure.

New Zealand levies tax on the profits of non-resident-owned firms that are sourced in New Zealand. These taxes should not be voluntary. Tax rules should not allow foreign-owned firms to sidestep paying taxes on their profits in New Zealand.

Almost all taxes are likely to have some negative effects on economic activity. In setting taxes on inbound investment there is a balance to be struck. Taxes should not unduly discourage inbound investment but we want the tax system to be robust. It is important that taxes are fair and seen to be fair.

…Deviations from normal tax rules, intended or otherwise, can lead to substitution of low-taxed investors for tax-paying investors, reducing national income without necessarily lowering the overall pre-tax cost of capital to New Zealand or increasing investment. Accordingly, base-maintenance provisions that ensure the intended level of tax is collected will often be in New Zealand's best interest."

99. Note that this is a secondary effect that arises from behavioural changes which officials are unable to quantify.

100. When resolving BEPS issues it is important that New Zealand remains an attractive place to base a business and invest. Taking a unilateral approach could harm New Zealand's reputation as a good place to do business, because New Zealand's tax treaty network could look less favourable relative to other countries' networks. However, a co-ordinated approach through the MLI minimises this risk by broadly simultaneously amending potentially several thousand treaties at the same time.

101. Regardless, the overall benefits of ratifying the MLI are expected to outweigh the costs.

The costs to New Zealand of compliance with the treaty

102. Normally, new DTAs or amending protocols constrain New Zealand from taxing certain income and limit the rate at which tax on passive income (dividends, interest, and royalties) can be imposed and therefore result in the reduction of New Zealand tax. However, this upfront revenue cost is typically offset by other factors (for example, through a reduced need for New Zealand to allow foreign tax credits for foreign income tax paid by New Zealand residents on foreign-sourced income).

103. The MLI differs in that its provisions are typically base protection measures which increase New Zealand's ability to tax inbound investment and equips New Zealand with a whole-of-treaty anti-abuse rule to prevent tax avoidance through the use of DTAs. This may result in more tax paid by non-residents in New Zealand.

104. However, as the provisions are reciprocal, the MLI may also increase the amount of foreign income tax paid by New Zealand residents with overseas investments and business operations. This could decrease the amount of net New Zealand income tax paid on that foreign income as a foreign tax credit is provided for foreign income tax paid.

105. Data limitations prevent officials from estimating the actual impact on net tax revenue. However, as New Zealand is a capital importer and the MLI covers the majority of New Zealand's DTA network, it is expected that the overall impact on tax revenue will be positive. A similar effect would be expected if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTA partners.

106. In terms of costs borne by Inland Revenue, there will be costs associated in administering the arbitration and other competent authority agreement provisions contained in the MLI. However, these are expected to be small and would be the same if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTA partners.

107. The existence of arbitration provides a strong incentive for revenue authorities to resolve issues under the MAP before arbitration can be triggered. New Zealand's DTAs with Australia and Japan already provide for arbitration and New Zealand's experience is that very few cases have been brought by taxpayers under the MAP and almost all of these have been settled within the required time period, regardless of whether the DTA provides for arbitration.

108. As mentioned above, there will be additional compliance and/or administrative costs associated with determining how the MLI modifies particular DTAs, producing guidance on the application of the MLI and using competent authority agreements to determine the treaty residence of dual-resident entities or challenging the application of specific anti-avoidance provisions such as the third state permanent establishment rule. While we are unable to quantify these compliance and administrative costs, we expect them to be modest and through consultation officials are working on ways to minimise these further.

109. Some of these compliance and administrative costs would still arise if instead of ratifying the MLI, New Zealand entered into individual amending protocols with each of its DTAs partners, for example in the context of competent authority agreements to determine the treaty residence of dual-resident entities or in challenging the application of specific anti-avoidance provisions.

110. Other costs are unique to the ratification of the MLI but would be offset by the benefits of the MLI. For example, the upfront compliance costs associated with determining how the MLI modifies particular DTA and the administrative costs associated with producing guidance on the application of the MLI would be offset by the savings made from not having to enter into bilateral negotiations with each DTA partner and then having to bring each amending protocol into force.

Completed or proposed consultation with the community and parties interested in the treaty action

111. The Treasury and the Ministry of Foreign Affairs and Trade were consulted about the content of this extended National Interest Analysis.

112. In addition, an officials' issues paper titled *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* was published in March 2017 and is available at www.taxpolicy.ird.govt.nz. While officials generally do not consult on the content of tax treaties, due to the complicated nature of the MLI, public feedback was sought on potential implementation issues related to the MLI. Two stakeholder workshops were held on 27 and 28 March 2017 with interested practitioners to enable officials to better understand practitioners' concerns. Submissions closed on 7 April 2017. Submissions received by that date were taken into account in the drafting of this extended National Interest Analysis, particularly in relation to the potential mitigation of identified disadvantages associated with New Zealand's ratification of the MLI.

Subsequent protocols and/or amendments to the treaty and their likely effects

113. After a jurisdiction's choices and reservations are confirmed at the time the instrument of ratification is deposited, that jurisdiction is still able to add new DTAs as DTAs covered by the MLI and withdraw their reservations (or reduce the scope of their reservations), but are unable to enter new reservations. The effect of this is that, following ratification, New Zealand (and other) jurisdictions can expand, but not narrow, the application of the MLI to their DTA network. This is provided for in Articles 28 and 29 of the MLI.

114. Article 33 provides that any party may propose an amendment to the MLI by submitting the proposed amendment to the Depository. Under Article 31 a "Conference of the Parties" could be convened to consider the proposed amendment at the request of the proposer, but only if one third of the parties to the MLI support the request within six calendar months of the request being communicated.

115. Article 38 provides that the MLI could be supplemented by one or more protocols. To become a party to such a protocol, one must be a party to the MLI, but parties to the MLI are not bound by such protocols unless they also become a party to that protocol.

116. New Zealand may enter into subsequent bilateral protocols which could supersede and replace the MLI provisions in a DTA.

117. Going forward, the MLI provisions are likely to form part of New Zealand's negotiating model and so will be generally incorporated into new DTAs.

Withdrawal or denunciation provision in the treaty

118. Article 37 provides that any party to the MLI may withdraw from the Multilateral Instrument at any time by notifying the Depositary. The withdrawal is effective from the date of receipt of the notification by the Depositary.

119. However, if the MLI has already entered into force for both parties to a DTA, then that DTA will remain modified by the Multilateral Instrument.

Agency Disclosure Statement

Inland Revenue has prepared this extended National Interest Analysis (NIA). Inland Revenue has analysed the issue of implementing the Multilateral Instrument, and the legislative and regulatory proposals arising from that implementation.

As part of that process, Inland Revenue considered the option of not entering into the MLI and instead retaining the status quo or entering into bilateral negotiations with each of New Zealand's DTA partners.

Inland Revenue is of the view that there are no significant constraints, caveats or uncertainties concerning the regulatory analysis. The policy aligns with the Government Statement on Regulation.

The provisional notifications and reservations lodged by New Zealand at the time of signature reflect the new OECD minimum and best practice standards relating to tax treaties. The position taken by New Zealand in the provisional notifications and reservations are consistent with the New Zealand negotiating model and will likely be incorporated into the New Zealand negotiating model going forward.

The revenue effect for New Zealand as a result of the changes under the MLI is expected to be negligible but potentially revenue positive due to New Zealand's status as a net capital importer.

An Order in Council will be required to give the MLI effect in New Zealand law. The Order in Council will override the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993; this is provided for under section BH 1 of the Income Tax Act 2007 and is necessary to give effect to the terms of the MLI.

The Treasury and the Ministry of Foreign Affairs and Trade have been consulted about the content of this extended NIA. An officials' issues paper on implementation issues associated with the MLI was released in March 2017 and the submissions received informed the analysis in this extended NIA.

Inland Revenue's view is that the policy options considered will not impose material additional costs on business interests; nor impair private property rights, market competition, or the incentives for business to innovate and invest; nor override fundamental common law principles.

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

9 May 2017

Annex A

Text of the MLI

Annex B

Notifications/reservations

Annex C

New Zealand has 40 DTAs currently in force. The table below shows the coverage of the MLI across New Zealand's treaty network (as at 9 May 2017).

	DTA	
Covered tax agreements	1.	Australia
	2.	Belgium
	3.	Canada
	4.	Chile
	5.	China
	6.	Czech Republic
	7.	Denmark
	8.	Finland
	9.	France
	10.	Germany
	11.	Hong Kong (China)
	12.	India
	13.	Indonesia
	14.	Ireland
	15.	Italy
	16.	Japan
	17.	Malaysia
	18.	Mexico
	19.	Netherlands
	20.	Poland
	21.	Russia
	22.	Singapore
	23.	South Africa
	24.	Spain
	25.	Sweden
	26.	Turkey
	27.	United Kingdom
	28.	Korea
Not modified by the MLI	29.	Switzerland
	30.	Viet Nam
	31.	Thailand
	32.	Philippines
	33.	Norway
	34.	Austria
	35.	United Arab Emirates
	36.	Papua New Guinea
	37.	Samoa
	38.	Taiwan
	39.	Fiji
	40.	United States

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Update on Multilateral Instrument

Date:	18 May 2017	**Priority:**	**High**
Security level:	Restricted	**Report no:**	T2017/1363 IR2017/320

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendation in this report	25 May 2016
Minister of Revenue	**Agree** to the recommendation in this report	25 May 2016

Contact for telephone discussion (if required)

Name	Position	Telephone
Carmel Peters	Policy Manager, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Jess Rowe	Senior Policy Advisor, Inland Revenue	[redacted]
Steve Mack	Principal Advisor, The Treasury	[redacted]

18 May 2017

Minister of Finance
Minister of Revenue

Update on Multilateral Instrument

1. On Monday 15 May 2017, Cabinet approved New Zealand's signature of the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI). CAB-17-MIN-0241 refers.

2. Cabinet also approved New Zealand's expected notifications and reservations, which included a list of 34 double tax agreements (DTAs) that New Zealand nominated to be covered by the MLI. T2017/1004; IR2017/260 explains why these 34 DTAs were chosen.

3. Jurisdictions' positions on the MLI are still subject to change. To allow New Zealand to respond to treaty partner's changing positions, Cabinet authorised the Minister of Finance and Minister of Revenue to approve any changes to the notifications and reservations as a result of developments in other jurisdictions' positions.

4. Yesterday the OECD advised that Papua New Guinea and the United Arab Emirates have joined the Ad Hoc Group on the MLI.

5. Accordingly, we recommend that you approve adding New Zealand's DTAs with these two countries to our list of nominated DTAs in New Zealand's expected notifications and reservations.

6. We do not yet know if these countries will list their DTAs with New Zealand. But by adding them to New Zealand's list, it means that if they sign the MLI and nominate their DTA with New Zealand, our DTAs with these countries will be modified to contain the improved BEPS provisions.

7. The final expected notifications and reservations must be provided to the OECD no later than 26 May to allow processing before signature of the MLI on 7 June 2017. Changes can be made after signature, but this would be procedurally unusual. Therefore, we recommend that addition of the Papua New Guinea and United Arab Emirates DTAs is made in the final version submitted to the OECD by 26 May 2017.

Recommended action

We recommend that you agree that New Zealand adds our double tax agreements (DTAs) with Papua New Guinea and the United Arab Emirates to the list of nominated DTAs in New Zealand's expected notifications and reservations provided to the OECD by 26 May 2017.

Agreed/Not agreed

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

Steve Mack
Principal Advisor
The Treasury

Agreed/Not agreed

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

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24 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS – summary of submissions on March 2017 discussion documents

Date:	15 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1630 IR2017/361

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to the recommendations	19 June 2017
Minister of Revenue	**Agree** to the recommendations	19 June 2017

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Gordon Witte	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Carmel Peters	Policy Manager, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	

15 June 2017

Minister of Finance
Minister of Revenue

BEPS – summary of submissions on March 2017 discussion documents

Executive summary

1. This report summarises the main points made by submitters on the two BEPS discussion documents released in March 2017:

- *BEPS – transfer pricing and permanent establishment avoidance* ("transfer pricing and PE avoidance"); and
- *BEPS – strengthening our interest limitation rules* ("interest limitation").

2. We received 43 submissions on these discussion documents in total – 16 submissions on the transfer pricing and PE avoidance discussion document, and 27 submissions on the interest limitation discussion document. A full list of all the submitters, together with a brief description, is included in the appendix to this report.

3. We have considered all the submissions in detail and we will report back to you with advice on these submissions next week. We will include recommendations that endeavour to meet the concerns raised by submitters to the greatest extent possible, while still achieving the desired policy objectives.

General reaction

4. Some general comments provided by submitters were similar for both discussion documents.

- Submitters acknowledged that it was important to address BEPS risks facing New Zealand and agreed in principle that change is needed to strengthen interest limitation, transfer pricing and PE rules.

- Submitters argued that the proposals will have a negative impact on New Zealand's attractiveness as an investment destination.

- Submitters indicated that the application date for all new law changes should be sufficiently prospective to allow taxpayers to restructure their affairs.

- A number of submitters also argued that existing advance pricing agreements (APAs)[1] should be grandparented and allowed to run their course.

Main issues raised by submitters

5. The main issues raised by submitters in relation to the specific proposals were:

- **The interest rate cap proposal should not proceed.** Many submitters on the interest limitation discussion document argued that no specific rule for limiting interest rates on related-party debt was necessary given the proposed strengthening of the transfer pricing rules (in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*). The allowable interest rate on related-party loans is currently set using transfer pricing, and submitters argued that strengthening the transfer pricing rules would be sufficient to address any concerns about interest rates on related-party loans.

- **Deferred tax should be carved out from the proposed non-debt liability adjustment.** The interest limitation discussion document proposed a change to how allowable debt levels are calculated under our thin capitalisation rules. A near-universal comment from submitters was that deferred tax liabilities should be carved out from the proposed adjustment. Deferred tax is an accounting concept – accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make; however, submitters argued that this is often not the case.

- **The PE avoidance rule should be more narrowly targeted.** Many submitters considered that the proposed rule could widen the PE definition in substance rather than just prevent avoidance. They were also concerned that it could capture ordinary commercial arrangements and discourage foreign investment.

- **The "time bar" for transfer pricing should remain at 4 years**. There was strong opposition to the proposal to extend the transfer pricing time bar to 7 years (in line with Australia's 7 year time bar). The time bar limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position.

Next steps

6. Officials are happy to discuss this report with you at your joint Ministers' meeting on 19 June. We will report back next week with advice and recommendations on these submissions and the other issues raised by submitters.

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[1] An APA is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years.

Recommended action

We recommend that you:

(a) **Note** the main issues raised by submitters.

Noted Noted

(b) **Note** we will report back next week (beginning 19 June) with advice and recommendations on these submissions and other issues raised by submitters.

Noted Noted

(c) **Discuss** this report with officials at your joint Ministers' meeting on 19 June.

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

7. Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinationals to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

8. New Zealand's tax system is already quite robust by international standards. However, there is room for improvement. As New Zealand is a strong supporter of the OECD's BEPS work, many of our BEPS measures are based on the recommendations from the G20/OECD Action Plan Report which seek to counter large multinationals engaged in aggressive BEPS tax practices. In response to the OECD's BEPS work, the New Zealand Government released a series of public consultation documents, including two discussion documents in March 2017:

- *BEPS – transfer pricing and permanent establishment avoidance* ("transfer pricing and PE avoidance"); and
- *BEPS – strengthening our interest limitation rules* ("interest limitation").

9. The Government received 43 submissions on these discussion documents in total – 16 submissions on the transfer pricing and PE avoidance discussion document, and 27 submissions on the interest limitation discussion document. A full list of all the submitters, together with a brief description, is included in the appendix to this report.

10. Most of the submitters are tax advisors or represent businesses that could be negatively affected by the proposals. Therefore, the submissions are understandably critical of some of the measures. However, submitters have also provided constructive suggestions on how the proposals could be redesigned or better targeted in order to reduce unintended impacts such as uncertainty for investors or double taxation. We are confident we can refine the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

11. This report summarises the main issues raised by submitters. We will report back with advice and recommendations on these submissions and other issues next week.

General issues raised by submitters

Submission: general support for addressing BEPS

12. Submitters acknowledged that it was important to address BEPS risks facing New Zealand and agreed in principle that change is needed to strengthen interest limitation, transfer pricing and PE rules. However, submitters did not agree with many of the proposed changes put forward in the discussion documents. Only two submitters supported all of the proposed changes in both documents (Oxfam and NZ Council of Trade Unions).

Submission: wider economic concerns

13. Many submitters argued that the proposals have the potential to significantly impact the flow of capital to New Zealand and the willingness of non-residents to establish business in New Zealand. Submitters argued that many of the proposals contained in the discussion documents could make New Zealand a less-attractive investment destination and, on this basis, should not be implemented (CTG, CA ANZ, Olivershaw, NFTC).

14. Some submitters on the PE avoidance proposals argued that the proposals introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand (CTG, CA ANZ, NFTC).

Submission: application date

15. The planned commencement date for these measures is income years starting on or after 1 July 2018. At the time the discussion documents were released, this commencement date was not publicly known.[2] However, many submitters anticipated the Government would seek an early commencement date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary (PwC, CTG, EY, CA ANZ).

16. Several submitters (including PwC and Powerco) submitted that the application date for these proposals should be no earlier than 1 April 2019.

17. A number of submissions on the interest limitation discussion document also argued that transitional rules should be provided for existing investments for up to five years post enactment.

Submission: grandparenting APAs

18. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. A large number of submitters expressed concern that APAs would be invalidated when the new legislation comes into effect. These submitters suggested that all existing APAs affected by

[2] The discussion document proposed that the measures would apply from income years beginning on or after the date that the new legislation was enacted.

the proposals in these discussion documents should be preserved under transitional rules for the term of the APA.

Comment

19. The majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that deliberately attempt to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

20. Furthermore, it is highly unlikely that foreign companies would remove their existing personnel from New Zealand as a result of the PE avoidance proposals, as most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. It is also very unlikely that they would cease to operate in New Zealand.

21. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

Interest rate cap

Summary of proposed rule

22. The interest limitation discussion document proposed moving away from a transfer pricing approach for pricing cross-border related-party loans, and instead proposed two new pricing rules (one for when a company has a foreign parent and one when it does not):

- An *interest rate cap,* which would apply when a New Zealand company has a foreign parent (e.g. it is a subsidiary of a multinational company). Under the interest rate cap, the allowable interest rate on related-party debt would be set with reference to the interest rate the parent company could borrow at.

- A *modified transfer pricing rule* when a New Zealand company has no foreign parent (e.g. it is owned by a group of non-residents acting together). Under the modified transfer pricing approach, the allowable interest rate on related-party debt would be determined using transfer pricing, but with a presumed set of conditions (including that the debt is senior unsecured debt issued on standard terms).

General reaction

23. This proposal – in particular the *interest rate cap* – was the focus of most submissions. Several submitters agreed that the rules for limiting the interest rate on related-party loans need strengthening, but only two submitters agreed with the proposed approach (Oxfam and NZCTU).

24. The general view of submitters was that the proposed interest rate cap should not be adopted at all, or if it is adopted, that it should only be a safe harbour, meaning that an interest rate higher than that provided for under the cap would be allowed if it can be justified under transfer pricing.

25. The proposal has also attracted positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.[3]

26. Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".[4]

Submission: interest rate cap proposal should not proceed

27. Submitters argued that the interest rate cap proposal was not necessary and should not proceed. They noted that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Submission: concerns with design and impact of interest rate cap proposal

28. Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm's length standard so would result in double taxation;
- will increase compliance costs;
- will apply to firms with a low BEPS risk; and
- has no international precedent

Comment

29. We agree that transfer pricing, with the modifications proposed in the discussion document *BEPS – Transfer pricing and permanent establishment avoidance* will limit the ability for taxpayers to use artificial or commercially irrational funding structures. However, we remain concerned that these rules would not be adequate to prevent taxpayers from choosing to borrow from related-parties using higher-priced forms of debt than they would typically choose when borrowing from third parties.

30. We will report back with our advice and recommendations in relation to these submissions.

[3] *Government plan to target tax avoidance cops criticism*, National Business Review, May 12 2017.
[4] Hoke, William, *Australian Court Rejects Chevron's Transfer Pricing Appeal*, Tax Notes International, May 1 2017.

Non-debt liability adjustment

Summary of proposed rule

31. The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand ("deductible debt"). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer's assets (generally, debt up to 60 percent of the taxpayer's assets is allowable).

32. The interest limitation discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (i.e. its liabilities other than its interest-bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

General reaction

33. Several submitters (including CA ANZ, EY and KPMG) indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

34. A number of other submitters (including CTG, PwC and several submissions representing the infrastructure industry) argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

Submission: deferred tax should be carved out

35. To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

36. All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, these deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

37. Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future;

- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

Comment

38. We have considered these submissions carefully, including discussing them with the agency in charge of setting accounting standards in New Zealand (the External Reporting Board or XRB) and the Australian Treasury. Our report next week will provide you with advice and recommendations on this issue.

PE avoidance

Summary of proposed rule

39. Where a DTA applies, New Zealand is only able to tax a non-resident on its income from sales to New Zealand customers if the non-resident has a PE in New Zealand. The discussion document proposed a rule to prevent non-residents from structuring their affairs to avoid having such a permanent establishment in New Zealand where one exists in substance.

General reaction

40. Submitters were not strongly opposed to a new PE rule in principle, with two submitters supporting the proposal (Oxfam, NZCTU) and the remainder mostly accepting the need (or inevitability) for some form of PE avoidance rule. However, seven submitters considered that we should not adopt any PE avoidance rule at this stage. These submitters argued that:

- The OECD's Multilateral Instrument (MLI)[5] includes a widened definition of a PE. Any PE avoidance issues should be addressed under this. Alternately we should defer consideration of a PE avoidance rule until the impact of the OECD's BEPS measures has been determined (EY, AmCham, DEG, CA ANZ).

- The rule is unnecessary, as any current issues with PE avoidance can be addressed through our transfer pricing rules (NZLS, DEG, CA ANZ).

- The rule will apply to non-abusive transactions, is outside the OECD's BEPS initiatives and will erode taxpayer certainty (CTG, NFTC, Deloitte).

Threshold for the application of the new measures

41. A majority of submitters (EY, NFTC, DEG, Deloitte, CTG CA ANZ, PwC, KPMG,

[5] The *Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting*. The MLI is a multilateral convention which is intended to prevent DTAs from being used to facilitate cross-border tax avoidance. The MLI amends a large number of each signatory's DTAs at once, and so implements the OECD's recommended DTA changes much faster than a succession of bilateral negotiations could. New Zealand signed the MLI on 7 June 2017.

Russell McVeagh) considered that the proposed PE avoidance test was too broad. They argued that it would widen the PE definition in substance rather than just prevent avoidance. They were also concerned that it could capture ordinary commercial arrangements and discourage foreign investment. Submitters suggested two options for narrowing the scope of the rule:

- the PE avoidance rule could be targeted at abusive or artificial arrangements; or
- New Zealand could adopt the wording of the OECD's widened PE avoidance definition in the MLI.

Overriding DTAs

42. A majority of submitters considered that our PE rule should not override our DTAs (CTG, KPMG, CA ANZ, NFTC, NZLS, EY, Russell McVeagh, DEG). This is because DTAs are important to international trade, and New Zealand exporters also need to rely on them. Submitters also considered that we should not depart from the OECD's agreed BEPS measures, particularly where the country of the non-resident has declined to adopt the widened PE definition in the MLI.

Comment

43. Our proposed PE avoidance rule is broadly consistent with the OECD's BEPS initiatives and measures adopted by the UK and Australia.

44. The OECD's Commentary to the Model Tax Convention (the Commentary) states that, as a general rule, there will be no conflict between domestic anti-avoidance provisions and the provisions of a DTA. It also confirms that States are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that this should not be lightly assumed). Accordingly, the proposed PE avoidance rule should not conflict with New Zealand's DTAs. We also note that both the UK and Australian PE avoidance rules over-ride their DTAs.

45. We will report back with advice and recommendations on these submissions.

Transfer pricing

Summary of proposed rules

46. Transfer pricing rules guard against multinationals using related-party payments to shift profits offshore by requiring these payments to be consistent with an arm's length or market price that unrelated parties would agree to. Chapter 5 of the discussion document outlined a package of proposals to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules.

General reaction

47. Three submitters (CTG, EY, KPMG) considered the transfer pricing proposals were unnecessary and argued that the existing transfer pricing rules are sufficient.

48. Other submitters generally accepted that there was a need to update New Zealand's transfer pricing legislation so it aligned with the OECD's new transfer pricing guidelines (which were developed to combat BEPS).

49. However, as expected, there was strong opposition to the proposal to extend the time bar for transfer pricing adjustments to 7 years.

Extending the time bar to 7 years

50. Inland Revenue currently has 4 years from the day that a taxpayer has filed an income tax return in which it can investigate and adjust the tax position taken by the taxpayer in their income tax return. This 4 year period is known as the time bar. The discussion document proposed that transfer pricing issues should have a longer time bar of 7 years (consistent with fact that Australia and Canada have 7-year time bars for transfer pricing).

51. Most submissions on the discussion document opposed this proposal. The main arguments raised by submitters were:

- A longer time bar increases uncertainty for taxpayers and does not promote efficiency in transfer pricing disputes (will delay timely resolution).
- The discussion document argued that a longer time bar is needed because transfer pricing issues are complex and fact-specific, but submitters noted that this is also true of other areas of tax such as tax avoidance, the capital / revenue boundary and complex financial arrangements.
- Most countries have the same time bar for transfer pricing and other tax issues, and in most cases this was less than 7 years.
- If a transfer pricing dispute is resolved in favour of Inland Revenue, the taxpayer will be at risk of double tax in jurisdictions where the time bar has already passed.
- Imposing a longer time bar is inconsistent with Inland Revenue's Business Transformation goals of real-time review and helping taxpayers get it right from the start.
- Inland Revenue should invest more resource into its transfer pricing team if the investigations are taking longer than 4 years.

Comment

52. We will report back with further advice and recommendations on this and the other transfer pricing submissions.

Next steps

53. Officials are happy to discuss this report with you at your joint Ministers' meeting on 19 June. We will report back with advice and recommendations on these submissions and other issues next week.

54. Subject to your decisions, we anticipate the following timeline:

Date	Milestone/action
Monday 19 June	Joint Ministers' meeting to discuss these reports and policy recommendations
Week commencing 19 June	• Report with advice and policy recommendations on transfer pricing and PE avoidance • Report with advice and policy recommendations on interest limitation
Week commencing 26 June	• Report on hybrids entities and instruments proposals sent to Ministers • Draft cover Cabinet paper with overview of the BEPS package to Ministers
Wednesday 5 July	Joint Ministers' meeting to discuss hybrids recommendations and draft cover Cabinet paper
Week commencing 10 July	Provide the following Cabinet Papers and RISs to Ministers: • Cover paper with overview of BEPS package • Transfer pricing and permanent establishment avoidance • Interest limitation • Hybrid mismatches
Thursday 20 July	Deadline for lodging Cabinet Papers in CabNet
Wednesday 26 July	EGI
Monday 31 July	Cabinet

55. Consultation on draft legislation and technical design details will take place following Cabinet decisions, with a planned BEPS bill to be introduced after the general election. To stay on track with the planned commencement date of income years starting on or after 1 July 2018, the BEPS bill will need to be introduced and have its first reading by 14 December 2017.

Appendix: List of submitters

Abbreviation	Full name	Description	IL[6]	TP[7]
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓	✓
AMP (Aus)	AMP Capital Investors Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓	
AMP (NZ)	AMP Capital Investors (New Zealand) Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓	✓
ANZ	ANZ Bank New Zealand Limited	ANZ is a major bank in New Zealand and Australia.	✓	
BNZ	Bank of New Zealand	BNZ is a major bank in New Zealand and Australia (NAB).	✓	
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓	✓
DEG	Digital Economy Group	DEG is an informal coalition of leading US and non-US software, information/content, social networking, and e-commerce companies that provide goods or services through digital and non-digital means.		✓
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓	✓✓[8]
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓	✓
First Gas	First Gas Limited	First Gas is one of NZ's largest gas networks.	✓	

[6] Submission received on *BEPS – strengthening our interest limitation rules*
[7] Submission received on *BEPS – transfer pricing and permanent establishment avoidance*
[8] Deloitte made two separate submissions on the *BEPS – transfer pricing and permanent establishment avoidance* discussion document.

Abbreviation	Full name	Description	IL	TP
First State	First State Investments	First State Investments (FSI) is the investment management business of the Commonwealth Bank of Australia.	✓	
InfraRed	InfraRed Capital Partners Limited	InfraRed is an active equity investor in the New Zealand PPP sector, currently holding interests in the Auckland South Correctional Facility and Transmission Gully Motorway projects.	✓	
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓	✓
Methanex	Methanex New Zealand Limited	Methanex produces and sells methanol globally. Methanex NZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China	✓	
NFTC	National Foreign Trade Council	NFTC is an association of approximately 250 United States business enterprises engaged in all aspects of international trade and investment.		✓
NZBA	New Zealand Bankers Association	NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks.	✓	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCTU is made up of 30 unions and has 320,000 members.	✓	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓	✓
Olivershaw	Olivershaw Limited	Olivershaw provides tax advisory services for corporate clients, corporate boards, high net worth individuals and accounting firms.	✓	
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty. Oxfam NZ is the New Zealand arm of the global organisation.	✓	✓
Plenary	Plenary Origination Pty Ltd	Plenary Group is an independent long-term investor, developer and manager of public infrastructure in Australia.	✓	

Abbreviation	Full name	Description	IL	TP
Powerco	Powerco Limited	Powerco is New Zealand's largest electricity distributer. It also has the second largest gas distribution network.	✓	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓	✓
QIC	QIC Private Capital Pty Limited	QIC is an investor in global infrastructure markets and manages a 58% interest in Powerco NZ Holdings Limited.	✓	
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓	✓
SKYCITY	SKYCITY Entertainment Group Limited	SKYCITY is an entertainment and gaming business owning and operating casinos in New Zealand (Auckland, Hamilton and Queenstown) and Australia (Adelaide and Darwin).	✓	
TPEQ	TP Equilibrium | AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓	✓
Westpac	Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch	Westpac is a major bank in New Zealand and Australia.	✓	

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

RECEIVED
6 JUL 2017
MINISTERIAL SERVICES UNIT

Tax policy report: Base erosion and profit shifting – overview of current reports

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1578 IR2017/329

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations	29 June 2017
Minister of Revenue	**Agree** to the recommendations	29 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Paul Kilford	Policy Manager, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Carmel Peters	Policy Manager, Inland Revenue	[redacted]
Steve Mack	Principal Advisor, The Treasury	[redacted]

22 June 2017

Minister of Finance
Minister of Revenue

Base erosion and profit shifting – overview of current reports

1. This report accompanies three papers providing further updates on the development of policy proposals introduced in three Government discussion documents on base erosion and profit shifting (BEPS):

- *Addressing hybrid mismatch arrangements* (released in September 2016);
- *BEPS – Strengthening our interest limitation rules* (released in March 2017); and
- *BEPS – Transfer pricing and permanent establishment avoidance* (released in March 2017).

2. We reported to you on 9 March 2017 with a summary of submissions received on the discussion document *Addressing hybrid mismatch arrangements* (T2017/460, IR2017/133 refers). We also reported to you last week with a summary of submissions on the two March 2017 discussion documents (T2017/1630, IR2017/361 refers).

3. This package of reports seeks policy decisions on a range of proposals relating to all three discussion documents, including a number of suggested refinements to address issues raised by submitters. The attached reports are:

- BEPS – interest limitation submissions and policy decisions (T2017/1576, IR2017/325);
- BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions (T2017/1577, IR2017/330); and
- BEPS – recommendations on addressing hybrid mismatch arrangements (T2017/1604, IR2017/353).

4. These reports also seek your approval for officials to prepare a set of four papers seeking Cabinet's agreement to policy decisions and to include the BEPS proposals in a tax bill later this year. Subject to your decisions and assuming you are comfortable with all the proposals, we anticipate the following timeline:

Date	Milestone/action
Thursday 29 June	Joint Ministers' meeting to discuss these reports and policy recommendations
Week commencing 10 July	Provide the following Cabinet papers and RISs to Ministers: • Cover paper with overview of BEPS package • Transfer pricing and permanent establishment avoidance • Interest limitation • Hybrid mismatches
Thursday 20 July	Deadline for lodging Cabinet Papers in CabNet
Wednesday 26 July	EGI
Monday 31 July	Cabinet

Further consultation

5. We recommend that, following Cabinet decisions in July, further consultation is undertaken on outstanding policy issues and technical design details relating to the BEPS package. We will report back to you on that consultation and any further feedback we receive on the proposals.

6. A number of submitters have also expressed interest in consultation on an exposure draft of the planned BEPS bill. We have signalled to submitters that an exposure draft could be provided on specific aspects of the proposals that are likely to be of most interest – for example, the permanent establishment anti-avoidance rule proposed in the discussion document *BEPS – Transfer pricing and permanent establishment avoidance.*

7. To stay on track with the planned commencement date of income years starting on or after 1 July 2018, the BEPS bill will need to be introduced and have its first reading by 14 December 2017. Due to this timing constraint, we are not proposing that submitters be consulted on an exposure draft of the entire bill. However, targeted drafting of specific sections where consultation will provide the most value is possible within this timeframe.

8. In the attached reports on interest limitation, and transfer pricing and permanent establishment avoidance, we have focused on the major issues relevant to the policy decisions to be made by Cabinet in July. We have not addressed all submissions on the March 2017 discussion documents that relate to technical or operational detail. We will advise you on such submissions following detailed design and further consultation with submitters. The hybrids report seeks more detailed final policy decisions because it has already been subject to a second round of consultation.

Fiscal implications

9. Some of the revenue for these proposals has already been included in Budget 2017 forecasts:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

10. If our recommendations in these four reports are agreed to and adopted by the Government, then the forecasts could be adjusted further by these amounts:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
BEPS measures – transfer pricing, permanent establishments, and interest limitation	0	0	45	90	90	90	90
BEPS measures – hybrid instruments	0	0	19	19	19	14	0
Total additional revenue effect	0	0	64	109	109	104	90

11. The additional revenue from certain hybrid instruments is a result of agreeing to the OECD hybrids recommendation 1 proposal with the grandparenting approach for these instruments recommended in the attached paper on hybrids. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

12. The total would come to the maximum revenue forecast for new BEPS measures that we have previously advised ($190 million per year for out years) and exceed this revenue forecast for the first four years in which the BEPS measures will apply. We are recommending in the report BEPS – interest limitation submissions and policy decisions (T2017/1576, IR2017/325 refers) that we continue to consult on details of the thin capitalisation proposal. Depending on the outcome of this consultation, the revenue forecast could be $10 million per year lower.

Economic implications

13. It is inevitable that the higher tax payments resulting from these measures will make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. At the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, random reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. Given this, we believe implementing these measures remains in New Zealand's best economic

interests.

Administrative implications

14. The changes proposed in the BEPS discussion documents and recommended in these reports are not expected to increase administrative costs or require any significant systems changes for Inland Revenue. This is because the reforms change the way some taxpayers self-assess their tax liabilities that they report to Inland Revenue.

15. We note, however, that a common theme in submissions on all three discussion documents was that administration of the proposals would place a higher demand on Inland Revenue's audit and investigation functions. Our view is that any required increase in Inland Revenue's resourcing as a result of the BEPS package will be accommodated within existing baselines. We will report back if these administrative implications are expected to change.

Application date

16. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

17. At the time the March 2017 discussion documents were released, this application date was not publicly known. However, many submitters anticipated the Government would seek an early application date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary. We expect to receive more feedback on the planned application date and other transitional issues in the next round of consultation.

Proactive release

18. We recommend that the Government consider proactively releasing submissions on the BEPS discussion documents and the MLI officials' issues paper, the BEPS Cabinet papers, and policy reports (including the pre-Budget 2017 Cabinet paper and policy report (T2017/949, IR2017/237)). This could be done at the time of announcements Ministers may want to make in relation to the package.

Recommended action

We recommend that you:

(a) **Note** the three reports attached.

Noted | Noted

(b) **Agree** that work progresses along the indicative timeline.

Agreed / Not Agreed | Agreed / Not Agreed

(c) **Agree** that the BEPS Cabinet paper should recommend that officials undertake further consultation on outstanding policy issues, technical design details and an exposure draft of selected items for the planned BEPS bill, with a view to introducing the bill after the General Election.

Agreed / Not Agreed | Agreed / Not Agreed

(d) **Agree** to proactively release the BEPS Cabinet papers, policy reports and submissions on consultation documents.

Agreed / Not Agreed | Agreed / Not Agreed

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

Steve Mack
Principal Advisor
The Treasury

Carmel Peters

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

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6 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS – interest limitation submissions and policy decisions

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1576 IR2017/325

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations	29 June 2017
Minister of Revenue	**Agree** to the recommendations	29 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Hamish Slack	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Steve Mack	Principal Advisor, The Treasury	
Carmel Peters	Policy Manager, Inland Revenue	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS – interest limitation submissions and policy decisions

Executive summary

1. In March this year the Government released the discussion document *BEPS – strengthening our interest limitation rules*. This report advises on the main issues relevant to the policy decisions to be made by Cabinet in July. Following this decision, we will design the detail of the proposals, on which we propose further consultation.

2. The use of debt is one of the simplest ways of shifting profits out of New Zealand. Robust rules limiting the use of debt (and limiting interest payments on that debt) are therefore important base protection measures. Accordingly, the discussion document proposed two key changes to these rules:

- a new method for limiting the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower (referred to as the interest rate cap), which we estimated would increase tax revenues by $40 million per year; and
- a change to how allowable debt levels are calculated under our thin capitalisation rules (referred to as an adjustment for non-debt liabilities), which we estimated would increase tax revenues by $50 million per year.

3. We received 27 submissions on the proposals. A full list of submitters is included in the appendix to this report. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals. In general, submitters acknowledged the need to respond to BEPS concerns. However, many submitters did not support the specific proposals put forward.

4. In summary, we are recommending several modifications to the original proposals put forward. We estimate these modifications will not affect the revenue estimate for the proposals (which was $90 million per annum from the 2018/19 year). However, as discussed below, we are proposing to consult further on the details of one of the proposals (to exclude deferred tax from the non-debt liability adjustment), the outcome of which could have a fiscal consequence. If deferred tax were to be entirely omitted from the proposal, the revenue forecast would reduce by $10 million per year.

Interest rate cap

5. The discussion document proposed replacing transfer pricing rules with a rule to cap the interest rate deduction allowed on related-party loans from a non-resident to a New Zealand borrower ("inbound related-party loans") based on the credit rating of the parent company - with a one-notch reduction for the New Zealand subsidiary. We viewed this interest rate cap proposal as a straight-forward, simple and non-manipulable way of pricing related-party debt. We considered that the cap was largely consistent with an arm's length approach under transfer pricing principles – albeit we accept that this would not be true in every case.

6. As a starting point, many submitters argued that no specific rule for limiting interest rates on related-party debt was necessary. Submitters noted that the Government has proposed to strengthen those rules generally (in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*). They thought that these strengthened rules should be sufficient to address any concerns about interest rates on related-party loans.

7. Submitters were concerned that the rule was novel and untested. They were concerned that New Zealand would stand out on its own and that this would deter FDI.

8. Another concern raised by submitters is that the cap would frequently result in double taxation because the foreign revenue authority would require a higher return on the debt and impose tax on that basis. (As explained in the body of our report, our view is that it is unlikely that our treaty partners will challenge this approach under our treaties.)

9. Some submissions highlighted the consequences of adopting a blunt rule in the nature of the cap. These include concerns that:

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating);
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

10. Following consultation and further analysis, we consider that if the Government pursued the interest rate cap, adjustments would be needed to the original proposal which would make it more complex. For example, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

11. The difficulty is, however, that simply relying on transfer pricing, as suggested by submitters, will not achieve the desired policy outcomes. It is clear that the international

consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. Commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions. Professor Richard Vann from Sydney University has said "transfer pricing has not proved up to the task of dealing with interest rates".

12. Accordingly, we recommend that the discussion document proposal be replaced by a *restricted transfer pricing* methodology. We consider this methodology is a better way of achieving the interest rate cap's objective and would have the same revenue impact. Like the cap, this approach will generally result in the interest rate on the related-party debt being in line with that facing the foreign parent. This is because, under the rule, debt will generally be required to be priced on the basis that it is "vanilla" (that is, without any features or terms that could push up the interest rate) and on the basis that the borrower could be expected to be supported by its foreign parent in the event of a default.

13. Implementing these restrictions in legislation will address the problem that the transfer pricing guidelines, in so far as they apply to related party debt, are open to interpretation, subjective, and fact intensive in their application.

14. We would recommend that the interest rate cap as initially proposed be available as a safe harbour. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable. We believe this would be an attractive option to many companies as it is both simple and provides certainty.

15. We also intend that access to the Mutual Agreement Procedure (MAP) under our Double Tax Agreements be available to taxpayers who consider that taxation under the new rule is inconsistent with the relevant treaty. This will address submitters' concerns about double taxation. We do not, however, expect many MAP cases will eventuate because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

16. We note that the Australian Taxation Office recently released draft guidelines, which are designed to incentivise Australian subsidiaries to structure their related-party loans into ordinary "vanilla" loans at interest rates similar to that facing their foreign parents. This will produce a similar result to the restricted transfer pricing approach we are recommending. However, the Australian guidelines are administrative measures – taxpayers are able to dispute them if they so choose.

Non-debt liability adjustment

17. The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand ("deductible debt"). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer's assets as reported in its financial accounts (generally, debt up to 60 percent of the taxpayer's assets is allowable).

18. The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

19. This proposal was accepted by some submitters but opposed by others, who argued for example that the proposal amounts to a substantial reduction in the amount of deductible debt allowable under the thin capitalisation rules. Overall, this proposal was much less contentious than the interest rate cap.

20. We consider this non-debt liability proposal should proceed. This is because the core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a taxpayer is limited to a commercial level of debt. A third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities. Moreover, the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. We note that Australia requires this same adjustment for non-debt liabilities.

21. A near-universal comment from submitters was that certain non-debt liabilities – most significantly *deferred tax liabilities* – should be carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept – accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. Submitters argued that this is often not the case – that deferred tax liabilities frequently are technical accounting entries and do not reflect future tax obligations. Submitters also pointed to the rules in Australia, which do include a carve-out for deferred tax liabilities and assets.

22. While many deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future, given the concerns raised by submitters, we recommend that we consult further on this matter. We could explore, for example, whether particular deferred tax liabilities that will not result in future tax payments could be identified and carved out from any adjustment. Note that the deferred tax balances of some taxpayers are significant – if a deferred tax exemption were provided, we estimate that this would reduce the fiscal impact of the non-debt liability proposal by up to $10m per year (from $50 million per year to $40 million per year).

Other proposals

23. Finally, the discussion document proposed several minor changes to the thin capitalisation rules. One of these proposals, which was generally welcomed, is a special rule for project finance. This proposal will allow full interest on third party debt to be deductible even if the debt levels exceed the thin capitalisation limit if the debt is non-recourse with interest funded solely from project income. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously. However, some technical issues have been raised which we will consult further on.

24. The other minor changes to the rules are summarised in the table below. Some of these were supported by submitters while others were opposed. Where they were opposed, we are recommending changes to the proposals that, in general, will address submitters' concerns.

Proposal in discussion document	Recommended approach
That the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of $1 million or less, be made available also to foreign-controlled taxpayers provided they have no owned-linked debt.	Submitters generally supported this proposal. We recommend that the proposal proceed without modification.
That when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.	Few substantive comments were received on this proposal. We recommend that the proposal proceed without modification.
Removing the ability for a company to use a value for an asset for thin capitalisation purposes that is different from what is used for financial reporting purposes, provided the valuation would be allowable under GAAP.	Submitters did not support this change, arguing it would result in high compliance costs. We recommend modifying this proposal to allow taxpayers to retain the ability to use asset values for thin capitalisation that differ from those reported in their financial accounts, but that clearer legislative requirements be developed for when this is option is utilised.
Removing the ability for a taxpayer to use their year-end debt and asset values for thin capitalisation purposes, so that debt and assets can only be valued for thin capitalisation based on average values at the end of every quarter or day.	Submitters did not support this change, arguing it would result in high compliance costs. We recommend that the proposal in the discussion document should not proceed, and instead we recommend inserting an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year.
A remedial amendment to section FE 18(3B) (regarding financial arrangements and trusts) to ensure it operates clearly.	Few substantive comments were received on this proposal. We recommend that this proposal proceed without modification.

Recommended action

We recommend that you:

(a) **Agree** that ordinary transfer pricing should not be used to price inbound related-party loans.

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** that the original proposal for limiting the interest rate on inbound related-party loans – the interest rate cap – should not proceed at this time.

Agreed/Not agreed Agreed/Not agreed

(c) **Agree** that the interest rate on inbound related-party loans should be set using a *restricted transfer pricing* approach, whereby the interest rate is set under transfer pricing but ignoring all surrounding circumstances, terms, and conditions that could result in an excessive interest rate unless similar terms apply to significant amounts of third-party debt, and with the presumption that the borrower would be supported by its foreign parent in the event of default.

Agreed/Not agreed Agreed/Not agreed

(d) **Note** that officials consider that, in general, this restricted transfer pricing approach would have a similar result to the interest rate cap that was originally proposed, and that therefore the original estimated forecast revenue of $40m per year from the 2018/19 year remains unchanged.

Noted Noted

(e) **Agree** that the precise design of this restricted transfer pricing approach should be subject to further consultation with submitters.

Agreed/Not agreed Agreed/Not agreed

(f) **Agree** that the proposed non-debt liability adjustment should proceed, so that a taxpayer's allowable debt level in the thin capitalisation rules is set with reference to its assets less its non-debt liabilities.

Agreed/Not agreed Agreed/Not agreed

(g) **Agree** that officials consult further on issues relating to deferred tax.

Agreed/Not agreed Agreed/Not agreed

(h) **Note** that if all deferred tax amounts were not included in the non-debt liability proposal, the revenue forecast from the proposal would be $10 million per year lower.

Noted | Noted.

(i) **Agree** that other technical exclusions to the non-debt liability adjustment be subject to further consultation with submitters.

Agreed/Not agreed | Agreed/Not agreed

(j) **Agree** that the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of $1 million or less, be made available also to foreign-controlled taxpayers provided they have no owner-linked debt.

Agreed/Not agreed | Agreed/Not agreed

(k) **Agree** in principle to an exemption from the thin capitalisation rules for certain infrastructure projects funded entirely with third-party limited recourse loans.

Agreed/Not agreed | Agreed/Not agreed

(l) **Agree** that the detailed design of this infrastructure exemption be subject to further consultation with submitters.

Agreed/Not agreed | Agreed/Not agreed

(m) **Agree** that, when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.

Agreed/Not agreed | Agreed/Not agreed

(n) **Agree** that existing arrangements affected by the change in (m) be grandparented.

Agreed/Not agreed | Agreed/Not agreed

(o) **Agree** that taxpayers should continue to be able to use asset values for thin capitalisation that differ from those reported in their financial accounts, but that clearer legislative requirements be developed for when this option is utilised.

Agreed/Not agreed | Agreed/Not agreed

(p) **Agree** that the proposed removal of the ability for a taxpayer to use their year-end debt and asset values for thin capitalisation purposes not proceed, and instead insert an anti-avoidance rule that applies when a taxpayer substantially repays a loan just before the end of the year.

Agreed/Not agreed | Agreed/Not agreed

(q) **Agree** that the minor remedial, relating to how section FE 18(3B) applies in relation to trusts, proceeds – that is, specifying that in order for a financial arrangement to be treated as owner-linked debt in relation to a trust, the owner must have made 5 percent or more (by value) of the settlements on the trust.

Agreed/Not agreed | Agreed/Not agreed

(r) **Agree** that advance pricing agreements (APAs) existing prior to the application date of these changes be grandparented.

Agreed/Not agreed | Agreed/Not agreed

Withheld under section 9(2)(a) of the Official Information Act 1982
[redacted]

Steve Mack
Principal Advisor
The Treasury

Carmel Peters
Policy Manager
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Background

25. In March the Government released the discussion document *BEPS – strengthening our interest limitation rules*. This report provides advice on the 27 submissions the Government received on the discussion document. It also seeks policy decisions on the proposals, including a number of suggested modifications to address issues raised by submitters.

26. We have met with many of the submitters (CA ANZ, CTG, PwC, KPMG, EY, NZBA) to discuss their submissions and explain the proposals. A full list of submitters is included in the appendix to this report.

27. This report advises on the important issues relevant to the policy decisions to be made by Cabinet in July. Following this decision, we will design the detail of the proposals, on which there will be further consultation.

General comments on the proposals

Submitters support interest limitation but not the particular proposals

28. Submitters acknowledged that it was important to address BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, as detailed below, submitters did not agree with many of the proposed changes put forward in the discussion document.

Submission: wider economic concerns

29. Many submitters argued that the proposals have the potential to significantly impact the flow of capital to New Zealand and the willingness of non-residents to establish business in New Zealand. Submitters argued that many of the proposals contained in the discussion document could make New Zealand a less-attractive investment destination and, on this basis, should not be implemented (CTG, CA ANZ, Olivershaw).

Response

30. We disagree with submitters on this matter. The majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that deliberately attempt to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

Submitters do not support an EBITDA-based approach for New Zealand

31. Most submitters were strongly against adopting an EBITDA-based rule as recommended by the OECD. Only one submitter (SKYCITY) discussed the merits of New Zealand adopting this approach – namely that it is advantageous for firms with assets that generate revenue but that cannot be recognised under accounting standards (such as casino licenses).

32. A key reason the other submitters did not support an EBITDA-based approach is that earnings can be volatile. A taxpayer that has interest deductions within the allowable limits one year could breach those limits the next if its revenues fall – even if that is because of factors outside their control (such as poor global economic conditions). Other reasons given by submitters were that:

- some industries have particularly volatile earnings, and these would be especially impacted by an EBITDA-based rule;
- such a rule may disadvantage groups that are heavily capitalised and have tangible fixed assets with long depreciation periods; and
- such a rule is not appropriate for commodity-based economies such as New Zealand.

33. We find the first of these arguments (volatility of earnings) particularly compelling. Provided a reasonable rule for limiting the interest rates of related-party debt can be developed (as discussed below), we do not see merit in adopting an EBITDA-based rule.

34. We note that Craig Elliffe, a professor of tax at Auckland University, reaches this same conclusion in a forthcoming academic article. He writes "... contrary to the strong recommendation in the OECD's report, there is no compelling case for change to an earnings-based EBITDA method from an assets-based regime".[1]

Concerns about horizontal inequity

35. Some submitters raised concerns that the proposals will result in horizontal inequity between businesses owned or controlled by offshore investors as compared with those in New Zealand. This is because the proposals predominately affect foreign-owned businesses.

36. We do not share these concerns. Foreign-owned businesses are able to reduce their New Zealand tax payments through the use of interest deductions in a way that domestically-owned firms cannot. Indeed, we consider the proposals will increase horizontal equity between foreign-owned and domestically-owned businesses.

Application to outbound investment

37. While the primary focus of the BEPS reforms is on foreign-owned businesses, similar base protection considerations can arise where New Zealand-owned businesses have offshore operations. For this reason, New Zealand's international base protection measures (such as the

[1] Craig Elliffe, *Interest deductibility: evaluating the advantage of earnings stripping regimes in preventing thin* capitalisation, forthcoming in the New Zealand Law Review (number two).

thin capitalisation rules and the transfer pricing rules) apply to both foreign-owned and domestically-owned businesses.

38. Consistent with this approach, the discussion document proposed that any changes ultimately adopted would apply to both foreign- and domestically-owned businesses.[2]

39. Three submitters disagreed with this approach, suggesting instead that the proposals should initially apply only to foreign-owned businesses. In particular, they were concerned that New Zealand-owned businesses with foreign-operations could be negatively impacted by the non-debt liabilities proposal.

40. We consider that the proposals should apply to outbound investment as originally proposed – as above, base protection concerns can arise with domestically-owned firms.

41. However, one submitter in particular (SKYCITY) has raised concerns with how the thin capitalisation rules operate for domestically-owned firms – in particular, that fact the rules do not take into account the value of some of its assets when determining its allowable level of debt causes them particular problems. We think this issue should be a subject of further consultation.

Submission: application date

42. The planned application date for these measures is income years starting on or after 1 July 2018. At the time the discussion documents were released, this application date was not publicly known.[3] However, many submitters anticipated the Government would seek an early application date and argued in their submissions that there needs to be sufficient lead-in time for these proposals to allow taxpayers to restructure their affairs if necessary (PwC, CTG, EY, CA ANZ).

43. Several submitters (including PwC and Powerco) submitted that the application date for these proposals should be no earlier than 1 April 2019.

44. A number of submissions on the interest limitation discussion document also argued that transitional rules should be provided for existing investments for up to five years post enactment.

Response

45. Cabinet has noted that the reforms are expected to commence from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on an expectation that the legislation will be progressed to enactment before this date.

46. We note that, in relation to the changes to the thin capitalisation rules (such as the non-debt liability adjustment), taxpayers would have until 30 June 2019 to adjust their balance

[2] Note that the proposal relating to the interest rate on related party debt applies to both foreign- and domestically-owned taxpayers, but applies only to inbound loans. We are not aware of any concerns regarding the pricing of outbound related-party loans.
[3] The discussion document proposed that the measures would apply from income years beginning on or after the date that the new legislation was enacted.

sheets as taxpayers have the ability to determine their thin capitalisation ratio based on their year-end asset and liability values.

Submission: grandparenting APAs

47. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling that confirms Inland Revenue agrees that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. A large number of submitters expressed concern that APAs would be invalidated when the new legislation comes into effect. These submitters suggested that all existing APAs affected by the proposals in the discussion document should be preserved under transitional rules for the term of the APA.

48. Without grandparenting of existing APAs, taxpayers may be disincentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.

Response

49. We agree that APAs existing prior to the application date of these proposals should be grandparented. There is a high cost and a rigorous process involved in obtaining an APA and it would be unfair if the new proposals rescinded APAs issued before the 1 July 2018 application date – especially considering APAs only run for five years.

Submissions on the proposed interest rate cap

Summary of proposed rule

50. When borrowing from a third-party, commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

51. The discussion document proposed moving away from a transfer pricing approach, and instead limiting the interest rates on related-party loans from a non-resident to a New Zealand borrower ("inbound related-party loans") – one for when a company has a foreign parent and one where it does not:

- An *interest rate cap,* which would apply when a New Zealand company has a foreign parent (for example, it is a subsidiary of a multinational company). Under the interest rate cap, the allowable interest rate on related-party debt would be set with reference to the interest rate the parent company could borrow at.

- A *restricted transfer pricing rule* when a New Zealand company has no foreign parent (for example, it is owned by a group of non-residents acting together). Under the modified transfer pricing approach, the allowable interest rate on related-party

debt would be determined using transfer pricing, but with a presumed set of conditions (including that the debt is senior unsecured debt issued on standard terms).

52. The purpose of these proposed rules was to ensure that the interest rate on related-party debt is roughly in line with what the borrower would actually agree to if they were borrowing from a third party.

General reaction

53. This proposal – in particular the *interest rate cap* – was the focus of most submissions. Several submitters agreed that the rules for limiting the interest rate on related-party loans need strengthening, but only two submitters agreed with the proposed approach (Oxfam and the CTU).

54. The general view of submitters was that the proposed interest rate cap should not be adopted at all, or if it is adopted, that it should only be a safe harbour, meaning that an interest rate higher than that provided for under the cap would be allowed if it can be justified under transfer pricing.

55. The proposal has also attracted positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.[4]

56. Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".[5]

Submission: transfer pricing changes should be sufficient

57. A recurring theme in the submissions is that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Response

58. Relying on transfer pricing, as suggested by submitters, will not achieve the desired policy outcomes.

59. The international consensus is moving away from using ordinary transfer pricing to limit interest expenses in relation to related-party debt. Concerns over highly-priced related-party debt were part of what was behind the OECD's recommended interest limitation rule based on EBITDA. Interest denial could result under an EBITDA rule even if the interest expense is appropriate as determined by the arm's length standard.

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[4] *Government plan to target tax avoidance cops criticism*, National Business Review, May 12 2017.
[5] Hoke, William, *Australian Court Rejects Chevron's Transfer Pricing Appeal*, Tax Notes International, May 1 2017.

60. The detail of the transfer pricing rules are "soft law". They are contained in the OECD transfer pricing guidelines to support the application of tax treaties. Most countries rely on them to solve transfer pricing issues even in the absence of a treaty. The transfer pricing guidelines take the form of guidance rather than set rules. We consider that, once amended as proposed in the *BEPS – transfer pricing and permanent establishment avoidance* discussion document, the transfer pricing rules will work well for non-debt items. However, because of the significant BEPS risks associated with related-party interest payments, we consider that the rule for such payments needs to be stronger, less subjective, and less open to interpretation." We note, for example, the Australian Taxation Office has stated that the recent Chevron case in Australia had cost them $10 million in external experts (not taking into account the cost of their own staff) even though it involved related-party interest payments that were, in our view, plainly excessive. [6]

61. In addition, transfer pricing does not adequately take account of the fact that related-party debt financing is fundamentally different to third-party debt financing. For example, subordinated debt[7] is less likely to be repaid compared to senior debt, and so carries a higher interest rate. This is appropriate in a third-party context: the higher interest rate compensates for the higher risk. However, in a related-party context, debt and equity are highly substitutable. The riskiness of a parent's investment in a subsidiary does not change whether it invests through equity (which would generate no deduction) or debt. We do not consider that related-party debt being subordinate to other debt should justify a higher interest rate.

Submission: various concerns with interest rate cap

62. Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm's length standard so would result in double taxation
- will increase compliance costs
- will apply to firms with a low BEPS risk
- has no international precedent.

Inconsistency with arm's length standard

63. Many submitters argued that the proposal is not consistent with the arm's length standard (the approach that underpins how countries apply the transfer pricing rules).
They argued that it will result in double taxation: the lender jurisdiction will price the loan under traditional transfer pricing, which will produce a higher interest rate than what would be allowable under the rate cap. For example, suppose for a loan between Canada and New Zealand, the Canadian Revenue Authority expects the loan to produce interest income at 7% but the proposed cap would allow deductions only of 5%. In this example, double taxation of the 2% difference would result.

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[6] Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62. The case involved a company owned by Chevron Australia borrowing in the USA at interest rates of about 1.2 percent in USD and on-lending the money to Chevron Australia at an interest rate of about 9 percent in AUD.

[7] Subordinated debt is a loan that ranks below other loans. In the case of borrower default, subordinated debt is repaid only once higher-ranked debt has been fully repaid.

64. As a more technical matter, submitters were concerned that if double taxation did arise, they would be denied the treaty resolution process if the interest rate cap was incorporated in the thin capitalisation regime rather than the transfer pricing rules.

65. Supporting the double taxation argument, submitters wrote that the New Zealand subsidiary of a multinational will generally have a higher credit risk than the parent. A traditional transfer pricing exercise would therefore result in a higher interest rate. Similarly, submitters saw the proposal as implicitly assuming that the New Zealand subsidiary would have the same credit risk as its foreign parent, and stated that this is not the case and does not represent commercial reality.

66. More generally, submitters were concerned that the interest rate cap would be inconsistent with our Double Tax Agreement (DTA) obligations. DTAs require arrangements (such as a loan) between a New Zealand company and a treaty-partner company to be treated for tax purposes as if it were entered into on arm's length terms – something submitters argued the cap would not do, since they submitted it would allow deductions for less than an arm's length amount of interest.

Compliance costs

67. Many submitters indicated that the proposed interest rate cap would increase compliance costs, even for firms with low gearing levels. They argued that the foreign jurisdiction in a cross-border loan transaction will still require a transfer pricing analysis of the loan for their own purposes (to ensure the interest rate on the loan is not too low), even if the same transaction was also priced using the interest rate cap in New Zealand.

68. Some submitters also wrote that the cap would be harder to apply when the foreign parent does not have a credit rating[8], as a credit scoring exercise for the foreign parent would have to be carried out (in contrast to when the parent had a credit rating – where the credit rating could simply be used).

Rule applies to firms at low risk of BEPS

69. Submitters were concerned that the interest rate cap would apply even if a firm had a very low level of debt. Submitters argued that this was inappropriate for two reasons:

- If a firm is concerned about the application of the interest rate cap (for example because of double taxation), there is no action the firm can take other than completely eliminating all related-party debt. Submitters contrasted this with the EBITDA rule as proposed by the OECD, which can also result in double taxation but firms are able to reduce the risk of this by reducing the amount of debt they hold.

- Firms with low debt levels, and therefore presenting a low risk of profit shifting using interest, could nevertheless suffer interest denial under the proposal (or alternatively incur costs in restructuring any related-party lending to ensure interest denial does not arise).

[8] Where the parent does not have a credit rating the application of the interest rate cap is not as straight forward. It is therefore not as appropriate as a safe harbour. About half of New Zealand's 300 largest foreign-owned companies have parents with credit ratings.

Rule has no international precedent

70. Some submitters were concerned that the proposed cap is novel and would not be well understood by foreign jurisdictions. Submitters argued that the proposed rules are not a co-operative approach to international tax policy and will be inconsistent with the OECD and all other countries.

Response

71. We do not agree with all the concerns raised but there were some valid issues to consider. Taking all the submissions, consultation, and subsequent analysis into account, we now recommend that the original proposal be replaced with a restricted transfer pricing approach. This alternative will still use, as a key component in the analysis, the cost of funds of the foreign parent; however, it will incorporate some limited flexibility, which we consider will address many of submitters' concerns. This alternative approach is discussed more below – following our analysis of key submissions which are still relevant to this alternative approach.

72. We do not agree with the argument that the interest rate cap is systematically inconsistent with the arm's length standard. On the contrary, we consider the cap will generally be consistent with the standard because of the transfer pricing concept of "implicit parental support". "Implicit parental support" is the notion that a foreign parent will stand behind a New Zealand subsidiary in the event of a default. That is, multinational groups generally do not let their local subsidiaries go under. "Implicit parental support" is a significant factor in transfer pricing analysis because it hypothesises that, as a commercial matter, it would affect what rate a third party lender would charge the New Zealand subsidiary and what that subsidiary would be prepared to pay. Accordingly, the credit rating of the foreign parent is a strong element in determining the credit rating of the New Zealand subsidiary.

73. Inland Revenue administers transfer pricing having regard to the concept of implicit parental support but some taxpayers do dispute it. Submissions on this were mixed. At one end of the spectrum, CTG said "An assumption of implicit parental support is not valid. A rational commercial lender would never rely on implicit support…" In general, the other submitters agreed that implicit support was a factor to be taken into account in applying the arm's length test. However, views varied on how important a factor it is.

74. We acknowledge that there would be cases when the interest rate cap would not produce an arm's length interest rate because, for instance, the New Zealand subsidiary is in a completely different line of business from the rest of the multinational group and has a different risk profile. Nevertheless, we do not accept that in these cases the interest rate cap would frequently result in double taxation. This is partly because the cap is not arbitrary (unlike EBITDA). Moreover, in our view, the shift in the international consensus makes it less clear that our treaty partners (especially Australia, given their guidance discussed below) would dispute the result of the cap under a treaty.

75. We agree that, as originally proposed, the interest rate cap would have produced some arguably inappropriate results. In particular, we agree with submitters' concerns that the cap would have applied regardless of a taxpayer's debt level in New Zealand. Yet if a firm has low levels of debt in New Zealand, it is unlikely that the structure of their loans (including their interest rates) has been driven by tax. Were the cap to proceed, we would recommend that it would apply more generously to taxpayers with lower debt levels.

76. We also acknowledge that applying the cap for New Zealand subsidiaries with foreign parents that do not have credit ratings might not be straight forward. Where the foreign parent has a credit rating, the allowable interest rate under the cap would be derived from that rating. However, where the parent has no credit rating, the credit worthiness of the parent would first have to be determined by a third party expert before the rate allowed by the cap could be calculated. While the advice we have is that this is not a difficult exercise in the scheme of things, it does result in more compliance costs for some taxpayers compared to others and may give rise to integrity issues.

77. Finally, we note that 16 of foreign-owned firms covered by Inland Revenue's International Questionnaire[9] were owned by consortiums of non-residents (and therefore have no identifiable foreign parent). Because there is no identifiable parent, the interest rate cap cannot apply to these businesses. The discussion document proposal was to apply a restricted transfer pricing approach to determine the rate on their shareholder debt funding. But we acknowledge the argument that having two sets of rules (a cap and a restricted transfer pricing approach) is a sub-optimal feature of the original proposal given the problem of excessive interest rates can arise regardless of whether there is a foreign parent.

78. Overall, if the Government were to pursue the interest rate cap proposal, we would recommend some adjustments which would add significant complexity. For instance, as above we would recommend adjusting its application for New Zealand subsidiaries with low levels of debt. This would mean that the cap applied differently to taxpayers depending on their circumstances. These differences create perceptions of unfairness. In addition, boundaries can be difficult to administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange matters so that they fall within certain boundaries.

Modified approach

79. We recommend that the discussion document proposal – whereby the foreign parent's credit rating is the *sole* determining factor of the New Zealand interest rate for related party debt, be replaced by a *restricted transfer pricing* methodology. Like the cap, this approach involves a strong presumption that the interest rate on the related-party debt would be in line with that facing the foreign parent. However, unlike the cap, a taxpayer would be able to deviate from this if they can show that it would be appropriate.[10] In addition, all the circumstances, terms and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer (or its foreign parent) can demonstrate that they have third party debt that features those terms or conditions.

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[9] Based on the International Questionnaire for the 2015 income year, which covered New Zealand's 314 largest foreign owned businesses (excluding banks and insurers).

[10] For example, if the New Zealand subsidiary is not wholly-owned by the parent, or if it operates in a substantially different industry to the parent.

80. We consider that this approach would, in general, achieve the same result as the interest rate cap but expect that it would be more acceptable to submitters. This is because it would only impact firms that do not have "vanilla" related-party debt. It also provides a limited amount of flexibility by allowing additional factors to be taken into account in addition to the foreign parent's credit rating when determining an appropriate interest rate in legitimate cases. This approach also has the advantage that it would apply consistently across taxpayers to the greatest extent possible.

81. Under this restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is strong presumption that the New Zealand subsidiary would be supported by its foreign parent in the event of default;
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
    - That the loan has no exotic terms that are generally not seen with third-party lending[11]
    - That the loan is not subordinated
    - That the loan duration is not excessive
    - That the debt level of the borrower is not excessive.

82. The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

83. If a taxpayer is able to demonstrate that it (or its parent) has substantial third-party loans with a particular feature, then that feature will not be required to be completely ignored. Instead, that feature will be an allowable factor in the pricing of the loan to the extent the taxpayer's third-party debt has that feature.

84. For example under this rule, an inbound related-party loan would generally be priced for tax purposes on the basis that it is not subordinated. However, if a taxpayer actually issues subordinated debt to third parties, then some amount of its related-party debt could also be priced as if it were subordinated. Similarly, a loan would generally be priced for tax as if its duration were not excessive, but if the taxpayer has third-party debt with a very long duration, its related-party debt could be priced as if it had a similarly long duration.

85. We consider that this approach would be effective in achieving the overarching objective of this project – which is to ensure that interest rates on related-party debt are

[11] The ATO's draft guidelines on related-party debt include a list of what could be considered an exotic term – including convertibility into equity, that the loan is repayable on demand, and contingencies (that is, interest is only repaid under certain conditions).

broadly similar to the interest rates that the borrower would actually agree to with third-party debt. The rule requires related-party debt to be priced as if it is an ordinary senior loan; however, if taxpayers can demonstrate that they raise debt from third-parties on other terms which result in higher interest rates, this can be taken into account.

86. We recommend that you agree in principle to the adoption of this restricted transfer pricing approach to determining the interest rate for related-party cross border loans. Its precise detail (for example, the wording of the required modifications, and what constitutes "excessive") would then be considered as part of further consultation.

87. This approach takes account of more factors than the interest rate cap, which focused solely on the foreign parent's cost of funds. However, this means the rule may be more costly for taxpayers to apply than the cap (particularly for subsidiaries of large multinationals that have credit ratings).

88. We recommend that the interest rate cap as initially proposed be available as a safe harbour. We believe this would be an attractive option to many companies as it is both simple and provides certainty.

89. This safe harbour could be provided either legislatively or administratively. We consider it likely that an administrative safe harbour is the best approach as it provides more flexibility. Nevertheless, we consider that would be a useful matter to consult on further.

90. We note that this rule would still apply in place of our standard transfer pricing rules. It could therefore be considered inconsistent with the arm's length principle, much like the interest rate cap. However, unlike the cap as originally proposed, we note that:

- if a taxpayer with a conservative level of debt borrows from its parent with a "vanilla" loan, there is no difference between this restricted transfer pricing approach and standard transfer pricing.

- lenders in countries that have a double tax agreement with New Zealand will be able to use the Mutual Agreement Procedure to alleviate any double taxation that may result because of this rule; however, as above, we do not consider this situation likely.

Australian guidelines

91. Since the release of the discussion document the Australian Tax Office released draft guidelines for the interest rates of cross-border related-party loans.[12] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, just like the restricted transfer pricing rule above, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The

[12] *ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions*, PCG 2017/D4.

ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

92. However, unlike what we have recommended, the Australian guidelines are administrative measures – taxpayers are able to dispute them if they so choose. Nevertheless, we think it appropriate to proceed with a law change as we are recommending. Given the manipulability of the general transfer pricing rules, we consider more robust measures are necessary to ensure related-party debt is appropriately priced.

Application of rule to banks

93. The discussion document did not propose exempting any particular industries from the interest rate cap.

Submissions

94. Following a discussion with the New Zealand Bankers Association (NZBA), we received submissions from NZBA and most of the large banks. These submitters argued that New Zealand banking groups should be excluded from the interest rate cap. The main arguments contained in these submissions are:

- Banks are subject to prudential regulation in both New Zealand (RBNZ) and Australia (APRA), which requires related-party loans to be priced on arms-length terms. These regulations also put restrictions on the type of debt that can be issued and the permitted level of support the Australian banks can provide to their New Zealand subsidiaries.

- Unlike most foreign-owned companies operating here, New Zealand's foreign-owned banks issue large amounts of third party debt. This makes transfer pricing exercises more straight-forward as there are clear comparable interest rates.

- Because banks are financial intermediaries (that is, in the business of borrowing from capital markets and then lending out that money), they will be most affected of all firms by a rule that limits the allowable interest rates on related-party debts.

Response

95. We agree that banks would have been disproportionately impacted by the interest rate cap as originally recommended. This is because banks, more than most businesses, rely on debt to fund their businesses, and because they regularly issue non-standard types of debt to third parties (such as debt that converts to equity in certain events). In addition, unlike most foreign-owned companies operating in New Zealand, New Zealand's foreign-owned banks regularly borrow significant amounts from third-parties. This means, when pricing a related-party loan between a New Zealand bank and its foreign parent, there are generally third-party comparables that can be used to ensure the interest rate on the related-party loan is not excessive.

96. We would have therefore recommended that registered banks be carved out from the interest rate cap. However, it is less clear that a carve-out from the approach we now recommend – the restricted transfer pricing approach – would be necessary. Under this method non-standard terms on related-party debt (such as convertibility into equity) would be allowable if the taxpayer can demonstrate that it (or its foreign parent) issues debt with those non-standard features. We consider that this is likely to be the case with the banks, as they (and their Australian parents) do regularly issue third-party debt with non-standard terms, for example.

97. Nevertheless, to ensure this rule would have no unintended consequences, we consider that the issue of whether banks should be subject to the restricted transfer pricing approach should be considered as part of the further consultation. We note that the original revenue forecast of $40m per year from the interest rate cap did not take into account any impact it might have on the banks; whether or not the restricted transfer pricing rule applies to them will have no impact on this revenue forecast.

Submissions on the treatment of non-debt liabilities

Summary of the proposal

98. The thin capitalisation rules limit the amount of deductible debt a taxpayer can have in New Zealand. Currently, the maximum amount of debt is set with reference to the value of the taxpayer's assets (generally, debt up to 60 percent of the taxpayer's assets is allowable).

99. The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts).[13] This is because the core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. For example, one of the objectives of the rules is to ensure that a taxpayer is limited to a commercial level of debt. We consider that a third-party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

100. Moreover, we are concerned that the current treatment of non-debt liabilities means companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in a company by its shareholders. For example, at present if a company purchases some inventory on deferred payment terms, its allowable debt level under the thin capitalisation rules will increase (because its assets have increased but its interest bearing debts have not). We do not consider that this is an appropriate outcome.

General reaction

101. Several submitters (including CA ANZ, EY and KPMG) indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

[13] Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

102. A number of other submitters (including CTG, PwC and several submissions representing the infrastructure industry) argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

103. Some submitters also argued that the existing 60 percent thin capitalisation safe harbour is already too low for infrastructure businesses – which are by nature highly geared and capital intensive – and so this proposal would disproportionately affect this industry's ability to stay within the 60 percent safe harbour.

104. Similarly, some submitters suggested introducing an additional arms-length test to allow taxpayers to gear at higher levels than the 60 percent safe harbour where that can be supported as a commercial level of debt. Submitters used the infrastructure industry as an example, where they argued that it is normal for third party debt to be secured on economic terms in excess of the 60 percent safe harbour ratio. Submitters suggested that an arms-length test would also address industry-specific concerns as noted above.

Response

105. At present, the thin capitalisation rules ignore non-debt liabilities. This means that companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment also means that companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

106. With regard to the specific points raised by submitters:

- we agree that in some cases the non-debt liability adjustment will increase volatility in thin capitalisation ratios; however, in other cases the adjustment will reduce volatility (such as when both assets and non-debt liabilities increase).

- We do not agree that the proposal amounts to a significant adjustment in the thin capitalisation safe harbour. This change only impacts taxpayers that have large non-debt liability balances. A taxpayer with only small non-debt liabilities will see very little change in its thin capitalisation ratio. In addition, this change will have no impact on a taxpayer if their thin capitalisation ratio remains below the 60 percent safe harbour (for example, even if the change results in a large increase in a taxpayer's ratio – say from 30 percent to 40 percent – the taxpayer will have no additional tax to pay as its ratio is still within the 60 percent safe harbour).

107. Overall, we do not consider that any of the points raised by submitters provide a reason not to proceed with the non-debt liability adjustment (subject to the modifications discussed below).

108. We agree with submitters that the 60 percent safe harbour will not always be appropriate, but consider that the thin capitalisation rules already adequately deal with these

situations. For example, a New Zealand company's debt level can exceed the safe harbour if it is still in line with the debt level of the company's multinational group (under what is known as the worldwide group debt test).We acknowledge that the use of the worldwide group debt test is rare; in our discussions with submitters we mentioned that we would be happy to look at changes to that rule if there are particular problems with its application in practice. No submissions were received on this.

109. With regards to implementing an arm's length debt test, we note that this was considered by the OECD as part of its work on best-practice interest limitation rules. The OECD recommended against such a rule, concluding that it is not an effective method for preventing profit shifting using debt. We do not recommend an arm's length debt test.

Submission: deferred tax should be ignored

110. To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

111. All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, these deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

112. Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity;
- that deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them;

113. Many submitters referred to the removal of building depreciation in Budget 2010 in making their arguments. The 2010 changes meant that companies that owned previously depreciable buildings needed to record a (sometimes significant) deferred tax liability, which will never result in a future tax payment.

Response

114. We have considered these submissions carefully, including discussing them with the agency in charge of setting accounting standards in New Zealand (the External Reporting Board or XRB) and the Australian Treasury.

115. Accounting standards require the recognition of deferred tax liabilities because a taxpayer may recognise a profit for accounting purpose that will not be taxable until a later period – the deferred tax liability represents that latent tax liability. However, we acknowledge in some cases deferred tax liabilities on a taxpayer's balance sheet will not accurately represent future tax payments the taxpayer will be required to make.

116. Our contact at the XRB made a similar remark, commenting that:

> "In many cases deferred tax balances are simply a timing difference between when income tax is expensed in the financial statements and when income tax becomes payable to the IRD; and in other cases, deferred tax balances recognised in the financial statements may have no impact on the current or future amount of income tax payable to the IRD.
>
> Many users of general purpose financial statements, which include significant deferred tax balances, consider the deferred tax balances and movements to be accounting entries that should be ignored when evaluating the financial performance and financial position of an entity. [...] The recognition of deferred tax adds a level of complexity and volatility to the financial performance reported, which many CFO's feel are unnecessary and result in deferred movements which are difficult to explain to shareholders."

117. Nevertheless, the fact remains that accounting standards require the deferred tax to be recognised – suggesting that they do often represent something real. Moreover, while some deferred tax liabilities will not result in future tax payments, not carving out deferred tax is consistent with the general policy taken in the thin capitalisation rules of following accounting principles.

118. The Australian Treasury commented that a key reason they carved out deferred tax from their non-debt liability adjustment is because of volatility concerns (mirroring comments made by submitters above). We agree that not carving out deferred tax could increase volatility of a taxpayer's thin capitalisation ratio in some instances, though consider that in many other situations it would also reduce it.

119. We recommend that we consult further on issues relating to deferred tax and the non-debt liability proposal. We could explore, for example, whether particular deferred tax liabilities that will not result in future tax payments could be identified and carved-out from any adjustment.

120. Deferred tax balances of some taxpayers are significant. If there was a carve-out for deferred tax, we estimate that this would reduce the fiscal impact of the non-debt liability proposal by up to $10 million per year (from $50 million per year to $40 million per year).

Submission: other technical adjustments

121. Submitters also wrote that it would be appropriate to make other exclusions from the non-debt liability adjustment, for example certain types of derivatives and redeemable preference shares. This was because, for example:

- they are more akin to equity;
- they are not used to fund a taxpayer's balance sheet; or
- that not excluding them would mean that taxpayers' thin capitalisation ratios would become inappropriately volatile.

Response

122. We consider that these other minor exclusions be considered as part of further consultation.

Submissions on other matters

De minimis for inbound thin capitalisation rules

Proposal

123. Many countries provide an exemption for companies with little interest expense, on the basis that they present a low BEPS risk. New Zealand has a de minimis in its outbound rules (of $1 million of interest deductions), but it does not currently have a de minimis in its inbound thin capitalisation. The discussion document proposed extending the existing de minimis so that it applies to inbound entities as well, provided none of the entity's debt is owner-linked debt (that is, debt from the owner, or that has been guaranteed by the owner).

Submissions

124. Submitters generally supported a de minimis rule on compliance cost saving grounds but wrote that limiting the proposed de minimis to firms with no owner-linked debt would make the de minimis very limited in application. CTG suggested that consideration should be given to adopting Australia's flat de minimis of $2 million which applies regardless of whether any lending is from related parties. Further to this, CA ANZ submitted that the outbound de minimis rule should be extended to $2 million as in Australia.

Response

125. If a firm has owner-linked debt, they present a higher BEPS risk than a firm with only third-party debt. On this basis, we consider that the proposed de minimis for inbound entities strikes the right balance between reducing compliance costs and BEPS risk.

126. Submitters did not provide any evidence that the current de minimis threshold in the outbound rules is too low. We do not consider it necessary to increase the current threshold from $1 million to $2 million as some submitters suggested.

Infrastructure projects

Summary of the proposal

127. The discussion document proposed adopting a rule presented in the OECD's final report on best-practice interest limitation rules, which would exempt certain infrastructure projects

funded entirely with third-party limited recourse loans from interest limitation rules. This exemption recognises that such funding presents little risk of BEPS.

Submissions

128. Submitters strongly supported this proposal. They wrote that it would make New Zealand a more attractive place for Public Private Partnership (PPP) investment and provide more flexibility in how such investments can be structured.

129. Submitters did make several technical submissions, primarily with a focus on ensuring the exemption works with the various commercial structures adopted by PPPs. We are currently working through these submissions. We note that further consultation with submitters may be necessary.

Response

130. We recommend that you seek Cabinet approval to this proposal in principle.

Non-resident owning body change

Proposal

131. At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level is the greater of:

- 60 percent; and
- 110 percent of its third-party debt.

132. We were concerned that allowing a company to have total debt of 110% of its third-party debt would allow entities to be funded through inappropriately high levels of debt. For example, a project funded 90 percent with third-party debt could have 9 percent shareholder debt and only 1 percent equity.

133. Accordingly, the discussion document proposed changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. The discussion document proposed grandparenting existing arrangements.

Submissions

134. This proposal was not a focus of many submissions. The main comments received were:

- That the proposed grandparenting of existing arrangements was appropriate; and
- That the way the proposal was worded implied it was unnecessarily restrictive.

Response

135. We recommend that this proposal proceed.

Asset valuations

Proposal

136. In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative to its financial statement value, provided that would be allowable under generally accepted accounting principles.

137. The discussion document proposed removing the net current valuation method from the list of available asset valuation methods for the purposes of the thin capitalisation rules. This change would mean that a company would only be able to use values as reported in its financial statements.

138. We proposed this change because we considered that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets. In addition, financial reporting valuations are subject to a higher level of scrutiny than asset valuations adopted solely for thin capitalisation purposes.

Submissions

139. No submissions on this proposal supported the removal of the net current valuation method. Many submitters argued that the flexibility to adopt an alternative valuation method is appropriate. They noted adopting a current valuation approach for financial reporting purposes means that the asset needs to be independently valued every year - an expensive exercise. In contrast, the current approach (where taxpayers can value assets at historic cost for financial reporting but based on current values for thin capitalisation) means taxpayers need to incur the costs of a valuation only when necessary (that is, when relying on an asset's financial value would mean the company would breach the thin capitalisation safe harbour).

140. Most submitters on this proposal suggested explicitly requiring revaluation of assets by an independent expert valuer, which is a feature of Australia's rules[14]). One submitter (CTG) also suggested that taxpayers should be required to disclose on their returns if the net current valuation method has been used. This would allow Inland Revenue to better target its resources while ensuring that taxpayers using the net current valuation method for genuine reasons are not unfairly penalised.

141. A few submitters suggested that the thin capitalisation rules should include all measurable assets, including intangible assets. This is consistent with Australia's approach. One submitter with significant intangible assets indicated that lenders look at the earning potential of intangibles and with sufficient rigour imposed on the process, there is no reason for intangible assets to be excluded from the thin capitalisation calculation.

Response

142. We are concerned about the robustness of the current rules (such as the risk that taxpayers are valuing assets without seeking an independent valuation) and the change

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[14] The legislation at present currently prescribes no such requirement, though we understand from submitters that it is standard practice to get an independent valuation.

proposed in the discussion document is aimed at ensuring asset values used by taxpayers for thin capitalisation purposes are robust. However, we understand that removing the net current valuation method could increase compliance costs for a number of firms.

143. On this basis, we recommend modifying this proposal to allow firms that meet certain conditions to use the net current valuation method. This modified approach would also be subject to robust legislative requirement (such as requiring revaluation of assets by an independent expert valuer as suggested by submitters, and ensuring a consistent valuation method is used year-to-year) to ensure asset valuations that are being used are robust.

144. We do not support the proposal of including intangible assets in thin capitalisation calculations. These assets – for example, internally-generated intellectual property – are very difficult to value, which is why they are not recognised as assets under New Zealand's accounting standards. We have discussed this suggestion with the Australian Treasury – they have informed us that the Australian Taxation Office has significant difficulty determining the value of intangible assets, and that they are seeing taxpayers increase their reported values for these assets in response to the recent tightening of their rules (thereby diminishing the impact of the tightening).

145. We note that the safe harbour rule that submitters are referring to is only one option available to taxpayers in the thin capitalisation rules. The worldwide group debt test can alternatively be used by those taxpayers concerned about breaching the 60 percent safe harbour due to the exclusion of intangible assets.

Measurement date for assets and liabilities

Proposal

146. Taxpayers can currently choose to value their assets and liabilities on the last day of the income year, or use an average of their values at the end of each quarter, or each day, in the income year.

147. The first of these methods, valuing assets and liabilities on the last day of the income year, is the simplest and most widely-used approach. However, there is the potential for a taxpayer to use this method to breach the thin capitalisation debt limits for up to one year without facing any interest denial, by partly repaying a loan or converting it to equity on or before their balance date.

148. The discussion document proposed removing the first of these asset valuation methods so that assets can only be valued for thin capitalisation based on the average values at the end of every quarter or at the end of every day. This would ensure that the thin capitalisation rules apply effectively to a loan that was substantially repaid just before the end of the year.

Submissions

149. No submissions on this proposal supported the removal of the year-end valuation option. In particular, submitters were concerned that requiring valuations on a quarterly or daily basis would impose significant and unnecessary compliance costs for the majority of

taxpayers subject to the thin capitalisation rules. Submissions indicated that the year-end valuation option is almost always used and that removing this option would require taxpayers to prepare audited financial statements solely for tax purposes at points in the year when they are not required for financial reporting purposes.

150. Submitters presented two alternative approaches:

- Calculating an average of the opening and closing values of assets and liabilities each income year. This approach features in Australia's rules.
- Implementing an anti-abuse rule in the thin capitalisation regime to tackle this type of tax-driven behaviour.

Response

151. We accept the submission that the proposal to require quarterly or daily valuation would impose significant compliance costs on the majority of corporate taxpayers. We note that both alternative approaches proposed by submitters have advantages and disadvantages. In particular, adopting the Australian approach would require most corporate taxpayers to change their measurement method, whereas a strengthened anti-abuse rule is far more targeted at taxpayers that present a higher BEPS risk.

152. We agree with submitters that the proposal in the discussion document should not proceed. Instead, we recommend adopting the suggestion by submitters to implement an anti-abuse rule that targets situations when a taxpayer substantially repays a loan just before the end of the year. This approach most directly targets the behaviour of concern.

Minor remedial

153. Finally, the discussion document proposed a minor remedial to how section FE 18(3B) applies in relation to trusts. Very few submitters commented on this proposal – the few that did (for example, CA ANZ) supported it.

154. We recommend that the proposal proceed without amendment.

Other issues not progressed

Finance companies

155. One submitter suggested that special rules for non-resident owned finance companies should be developed. For technical reasons, the thin capitalisation rules are not currently very effective for these companies.

156. We agree that special rule for finance companies (similar to the special regime currently in place for registered banks) is necessary to ensure the thin capitalisation rules apply effectively to them. However, such rules would be complex to develop. Furthermore, a review of Inland Revenue data indicated that foreign-owned finance companies do not present much BEPS risk at present. Accordingly, in developing the proposals for the discussion document

we focused on other, more pressing areas of reform. We recommend the development of a special rule for foreign-owned finance companies be considered for a later time.

Non-residents acting together with New Zealand residents

157. Broadly, the inbound thin capitalisation rules apply only to companies where 50% or more of the ownership interests are held by:

- a single non-resident; or
- a group of non-residents acting together.

158. This means that the thin capitalisation rules do not necessarily apply if a company is owned by a group of residents and non-residents acting together, even though similar profit shifting risks can arise. Two submitters questioned this result.

159. We agree that it would be desirable to review whether the situations when the thin capitalisation rules apply should be broadened further. However, this matter was not discussed in the original discussion document. Submitters have had no opportunity to comment on the appropriateness or otherwise of such a broadening. As such, we consider that a change at this time would not be appropriate.

160. We recommend that this be considered in any subsequent review of the rules.

Link to recent NRWT reforms

161. The Government recently bolstered the withholding tax rules on interest payments to non-residents, ensuring they cannot easily be structured around. Four submitters suggested that this means the proposals put forward in the discussion document are unnecessary.

162. We do not agree. NRWT on interest payments is taxed at either 10 or 15 percent (depending on whether the payment is to a jurisdiction New Zealand has a DTA with). This rate is much lower than the company rate of 28 percent. It is therefore important for New Zealand to have robust rules to ensure that excessive interest deductions are not taken in New Zealand, as this still substantially reduces the overall tax take in New Zealand.

Appendix: List of submitters

Abbreviation	Full name	Description	TP[15]
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓
AMP (Aus)	AMP Capital Investors Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	
AMP (NZ)	AMP Capital Investors (New Zealand) Limited	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓
ANZ	ANZ Bank New Zealand Limited	ANZ is a major bank in New Zealand and Australia.	
BNZ	Bank of New Zealand	BNZ is a major bank in New Zealand and Australia (NAB).	
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓
First Gas	First Gas Limited	First Gas is one of NZ's largest gas networks.	
First State	First State Investments	First State Investments (FSI) is the investment management business of the Commonwealth Bank of Australia.	
InfraRed	InfraRed Capital Partners Limited	InfraRed is an active equity investor in the New Zealand PPP sector, currently holding interests in the Auckland South Correctional Facility and Transmission Gully Motorway projects.	

[15] Submission also received on *BEPS – transfer pricing and permanent establishment avoidance*.

Abbreviation	Full name	Description	TP
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓
Methanex	Methanex New Zealand Limited	Methanex produces and sells methanol globally. Methanex NZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China	
NZBA	New Zealand Bankers Association	NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks.	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCTU is made up of 30 unions and has 320,000 members.	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓
Olivershaw	Olivershaw Limited	Olivershaw provides tax advisory services for corporate clients, corporate boards, high net worth individuals and accounting firms.	
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty. Oxfam NZ is the New Zealand arm of the global organisation.	✓
Plenary	Plenary Origination Pty Ltd	Plenary Group is an independent long-term investor, developer and manager of public infrastructure in Australia.	
Powerco	Powerco Limited	Powerco is New Zealand's largest electricity distributer. It also has the second largest gas distribution network.	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓
QIC	QIC Private Capital Pty Limited	QIC is an investor in global infrastructure markets and manages a 58% interest in Powerco NZ Holdings Limited.	
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓

Abbreviation	Full name	Description	TP
SKYCITY	SKYCITY Entertainment Group Limited	SKYCITY is an entertainment and gaming business owning and operating casinos in New Zealand (Auckland, Hamilton and Queenstown) and Australia (Adelaide and Darwin).	
TPEQ	TP Equilibrium | AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓
Westpac	Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch	Westpac is a major bank in New Zealand and Australia.	

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

RECEIVED

6 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1577 IR2017/330

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations	29 June 2017
Minister of Revenue	**Agree** to the recommendations	29 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Gordon Witte	Senior Policy Advisor, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Sam Rowe	Senior Policy Advisor, Inland Revenue	
Steve Mack	Principal Advisor, The Treasury	
Carmel Peters	Policy Manager, Inland Revenue	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions

Executive summary

1. In March this year the Government released a tax discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed the introduction of a package of transfer pricing and permanent establishment (PE) avoidance rules targeted at countering large multinationals engaged in aggressive tax practices. This report provides advice on the 16 submissions we have received on this discussion document. It also seeks policy decisions on the reform package following this consultation.

2. In summary, we recommend proceeding with all but one of the proposals in the discussion document (we do not recommend proceeding with the proposal to require large multinationals to pay disputed tax earlier). We recommend making a number of refinements to some of the original proposals in response to submissions. These refinements will make the proposals more certain for taxpayers and better targeted at the base erosion and profit shifting (BEPS) arrangements we are concerned about.

3. Agreeing to our recommended changes will not change the previously estimated forecast tax revenue from the transfer pricing and PE proposals (which is $25m in 2018/19 and $50m per annum thereafter).

Summary of submissions

4. Two submitters (Oxfam and NZCTU)[1] expressed support for all the proposals on the grounds that they would help ensure multinationals pay their fair share of tax.

5. Most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more workable and better targeted. Many submissions focused on when the PE avoidance rule would apply and when Inland Revenue would reconstruct a transfer pricing arrangement. We are confident we can refine the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

[1] A full list of all the submitters, together with a brief description, is included in the appendix to this report.

6. Some submitters were opposed to proceeding with any of the proposed measures as they considered the new rules were unnecessary and would make New Zealand's tax environment more uncertain and unattractive for multinational investment.

7. Most of the submitters are tax advisors or represent businesses that could be negatively affected by the proposals. Therefore, the submissions are understandably critical of some of the measures. As expected, submitters strongly opposed the proposals that increased Inland Revenue's powers to investigate large multinationals. These administrative proposals included:

- extending the transfer pricing time bar from 4 years to 7 years. This is the period within which Inland Revenue can adjust a transfer pricing tax position taken by a taxpayer;
- allowing Inland Revenue to request information that is held by an offshore group member; and
- requiring large multinationals to pay disputed tax upfront (rather than at the end of a dispute).

Our response

8. We agree with submitters that the proposal to make large multinationals pay disputed tax upfront is unnecessary, and recommend not proceeding with the proposal. Inland Revenue already charges "use of money interest" on tax owing, which provides a strong incentive for paying tax which is in dispute.

9. We recommend proceeding with all of the other proposals in the discussion document, subject to a number of refinements to make the proposals more certain for taxpayers and better targeted. These refinements should not reduce the overall effectiveness of the proposed reforms.

10. Otherwise, we consider the measures are well-targeted at the specific problems that Inland Revenue has actually observed in its investigations of multinationals. Currently only a small number of multinationals use the aggressive PE avoidance or transfer pricing arrangements which are targeted by the proposals. This suggests the new rules will only increase uncertainty or tax costs for a small number of multinationals.

11. The following table summarises the main issues raised by submitters and our recommended responses:

Submission	**Recommended response**
The anti-avoidance threshold for the application of the PE avoidance rule should be narrowed so it does not apply to ordinary commercial arrangements.	**Accept** the submission. We consider the rule should be more narrowly targeted at avoidance arrangements. We could do this either by requiring a more than merely incidental purpose of tax avoidance, or by adopting into domestic legislation the OECD's widened PE definition. We would like to give further

	consideration as to which approach we should adopt.
The PE avoidance rule is not necessary in light of the OECD's new widened PE definition (which New Zealand is implementing with some countries through the Multilateral Instrument and through future double tax agreement (DTA) negotiations).	**Accept** the submission in part. In cases where the applicable DTA includes the OECD's new widened PE definition, the proposed PE avoidance rule seems unnecessary. However the OECD's widened PE definition will not be included in most of our DTAs under the MLI (although it may be included under subsequent bilateral DTA negotiations). To reflect this, we recommend that the proposed PE rule apply only where an applicable DTA does not include the OECD's widened PE definition.
The PE avoidance rule should not override New Zealand's DTAs.	**Decline** the submission. For the rule to be effective it needs to override those DTAs which do not include the OECD's new widened PE definition. This is consistent with the Australian and UK approaches.
The proposed anti-avoidance source rule is too broad and should be more targeted at the perceived problem.	**Accept** the submission. We consider the rule should be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
The life insurance proposals represent an unfair and unilateral reconstruction of the tax treatment of life insurance premiums and should not proceed.	**Accept** the submission in part. We consider that the proposed reinsurance amendments are necessary to ensure that the rules apply as intended and to protect the tax base. However, there is little revenue at risk in relation to the foreign investment fund amendments and a significant likelihood of accidental non-compliance under the proposed change. Accordingly, we recommend that the foreign investment fund related life insurance changes do not proceed (meaning that any life insurance policies issued in New Zealand by life insurers from Singapore, Russia, and Canada would remain exempt from the foreign investment fund rules).
The time bar which limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position should remain at 4 years (not be extended to 7 years as proposed).	**Decline** the submission. We consider there is still a good justification for extending the time bar to 7 years for transfer pricing issues (consistent with Australia and Canada).
The burden of proof for transfer pricing matters should remain with Inland Revenue (rather than being shifted onto the taxpayer as proposed).	**Decline** the submission. The burden of proof is on the taxpayer for transfer pricing matters in most OECD and G20 countries, including Australia. This means most multinationals already have to prepare transfer pricing documentation that satisfies the burden of proof for other countries. Also, the burden of proof is on the taxpayer for other tax matters.

The test for reconstructing a transfer pricing arrangement should align with the OECD's transfer pricing guidelines.	**Accept** the submission. New Zealand's legislative test for reconstructing an arrangement should be based on the corresponding test in the OECD's transfer pricing guidelines.
The proposal to make large multinationals pay disputed tax upfront is unnecessary and should not proceed.	**Accept** the submission. We recommend not proceeding with this proposal as Inland Revenue already charges "use of money interest" on tax owing, which provides a strong incentive for multinationals to pay tax that is in dispute.
The proposal to require a New Zealand member of a multinational group to pay tax owed by a related non-resident group member should not proceed.	**Decline** the submission. However, we agree that the rule should only apply if the non-resident fails to pay the tax itself.
The proposed extension of Inland Revenue's information collection powers to allow Inland Revenue to request information that is held offshore by a related group member should not proceed. Submitters also raised concerns about the new civil penalty of up to $100,000 for failing to provide requested information (which replaces the current $12,000 maximum criminal penalty).	**Decline** the submissions. We consider that these information proposals are necessary to ensure that the multinational group is required to provide Inland Revenue with the requested information and has appropriate incentives to comply with these requests. However, we recommend allowing the multinational to appeal the penalty.

12. We also propose widening the scope of the original proposal to deem an amount of income to have a New Zealand source under our domestic legislation if we have a right to tax the income under a DTA. The rule proposed in the discussion document was limited to income covered by the PE and royalty articles of our DTAs. We should extend the rule to all types of income that we can tax under a DTA – as Australia does. This ensures we can exercise a taxing right that we have negotiated under a DTA. We will consult further on this wider proposal in the next round of consultation.

13. Officials are available to discuss this report at your joint Ministers' meeting on 29 June. Further information about the next steps is set out in the cover report included in this package (*BEPS – submissions on March 2017 discussion documents – covering report* T2017/1578 / IR2017/329).

Recommended action

We recommend that you:

(a) **Agree** that the proposal in the discussion document to require large multinationals to pay disputed tax upfront should **not** proceed as it is not necessary given that Inland Revenue already charges "use of money interest" on tax owing.

Agreed / Not Agreed Agreed / Not Agreed

(b) **Note** that the recommendations below agree to implement all the other proposals in the discussion document, subject to some refinements in response to submissions (as identified in this report).

Noted Noted

(c) **Note** that the recommended refinements will provide more certainty for taxpayers without reducing the overall effectiveness of the proposed reforms. Therefore agreeing to officials' recommendations will not affect the estimated forecast tax revenue from implementing the transfer pricing and PE avoidance measures, which is $25m in 2018/19 and $50m per annum thereafter.

Noted Noted

(d) **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure to avoid having a permanent establishment (taxable presence) in New Zealand. The rule will only apply to multinationals with over EUR €750m of consolidated global turnover.[2] The rule will not apply if the relevant DTA already includes the OECD's new widened PE definition.

Agreed / Not Agreed Agreed / Not Agreed

(e) **Note** that, in designing the detail of the new PE avoidance rules, officials will consider options for narrowing the original scope of the PE avoidance rules without reducing their effectiveness. We will report back with our recommendations on this matter.

Noted Noted

(f) **Note** that we will consult further on a new source rule which will deem an amount of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA.

Noted Noted

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[2] The EUR €750m threshold has been chosen to align application of the proposed rule with the OECD's threshold for requiring large multinationals to file country-by-country reports

(g) **Agree** to introduce an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source. (This is more narrowly targeted at the existing issues Inland Revenue has identified with the source rules than the original proposal.)

Agreed / Not Agreed | Agreed / Not Agreed

(h) **Agree** to address a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life insurance policies if the premium income on that policy is not taxable in New Zealand including where the income is not subject to New Zealand tax under a DTA.

Agreed / Not Agreed | Agreed / Not Agreed

(i) **Agree** that the proposal to amend the FIF life insurance rules should not proceed as there is little revenue at risk and a significant likelihood of accidental non-compliance under the proposal.

Agreed / Not Agreed | Agreed / Not Agreed

(j) **Agree** that the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position should be increased to 7 years (in line with Australia).

Agreed / Not Agreed | Agreed / Not Agreed

(k) **Agree** that the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions should be shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters).

Agreed / Not Agreed | Agreed / Not Agreed

(l) **Agree** to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. This involves amending New Zealand's transfer pricing rules so that:

- they disregard legal form if it does not align with the actual economic substance of the transaction;
- they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;
- the legislation specifically refers to arm's length conditions and using the latest OECD's transfer pricing guidelines as guidance material for how the rules are applied; and

- the new legislation codifies the requirement that large multinationals will provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative.

Agreed / Not Agreed   Agreed / Not Agreed

(m) **Agree** that New Zealand's legislative test for reconstructing a transfer pricing arrangement should be based on the corresponding test in the OECD's transfer pricing guidelines.

Agreed / Not Agreed   Agreed / Not Agreed

(n) **Agree** that in addition to applying to transactions between related parties, the transfer pricing rules should also apply when non-resident investors "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.

Agreed / Not Agreed   Agreed / Not Agreed

(o) **Agree** that if a large multinational group (over EUR €750m worldwide revenues) does not cooperate with Inland Revenue, then Inland Revenue may more readily dispute the multinational's tax position based on the information available to Inland Revenue at the time.

Agreed / Not Agreed   Agreed / Not Agreed

(p) **Agree** that tax owed by any member of a large multinational group can be collected from any wholly-owned group member provided the non-resident fails to pay the tax itself (this is slightly narrower than the original proposal in the discussion document).

Agreed / Not Agreed   Agreed / Not Agreed

(q) **Agree** to extend Inland Revenue's information collection powers so that in respect of large multinational groups, Inland Revenue can request information that is held offshore by a related group member.

Agreed / Not Agreed   Agreed / Not Agreed

(r) **Agree** to extend Inland Revenue's information collection powers so that Inland Revenue can deem an amount of income to be allocated to a New Zealand group member or New Zealand PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand-sourced income. (Currently the existing power only applies in respect of deductible payments.)

Agreed / Not Agreed   Agreed / Not Agreed

(s) **Agree** to create a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty), but clarify that the taxpayer would be able to appeal this penalty.

Agreed / Not Agreed | Agreed / Not Agreed

(t) **Agree** that advance pricing agreements (APAs) existing prior to the application date of these proposals should be grandparented.

Agreed / Not Agreed | Agreed / Not Agreed

Withheld under section 9(2)(a) of the Official Information Act 1982

[redacted]

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Background

14. In March this year the Government released a tax discussion document called *BEPS – transfer pricing and permanent establishment avoidance.* This report provides advice on the 16 submissions (from 15 submitters) we have received on this discussion document. It also seeks policy decisions on the proposals, including a number of suggested refinements to address issues raised by submitters.

15. We have met with six of the main submitters (CA ANZ, CTG, PwC, KPMG, EY, DEG) to discuss their submissions and explain the proposals. We will continue to work with these and other submitters to develop the detailed design of the legislation.

16. This report advises on the important issues relevant to the main policy decisions to be taken by Cabinet in July. Following these decisions, we will design the detail of the proposals, on which there will be further targeted consultation in August to October of this year. A number of the submissions related to the detail of the proposals or to Inland Revenue's operational approach. For example many taxpayers asked that Inland Revenue develop practical guidance on how the proposed new rules would apply. We will advise you on these detailed design and operational submissions following the next round of consultation.

General views on the proposals

17. The proposed transfer pricing and PE avoidance rules are targeted at countering large multinationals engaged in aggressive tax practices.

18. Some submitters welcomed these proposals as a positive step by the Government to ensure that all large multinationals pay their fair share of tax (Oxfam and CTU).

19. Most submitters accepted in principle the need for measures to address the transfer pricing and permanent establishment (PE) avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more workable and better targeted. Many submissions focused on when the PE avoidance rule would apply and when Inland Revenue would reconstruct a transfer pricing arrangement.

20. Other submitters argued that the proposals will have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented (CTG, CA ANZ, and NFTC). These submitters argued that the proposals introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, which would reduce GDP and lower employment levels.

21. We disagree with these submissions. First, the majority of multinationals operating in New Zealand are compliant and the Government is committed to making sure New Zealand remains an attractive place for them to do business. However, there are some multinationals that set out to circumvent New Zealand's tax rules. These multinationals should not be allowed to exploit weaknesses in the transfer pricing and PE rules to achieve a competitive

advantage over more compliant multinationals or domestic firms. Second, it is highly unlikely that foreign companies will remove their existing personnel from New Zealand as a result of these proposals. Most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

22. The transfer pricing and PE proposals introduce a set of rules to reinforce the integrity and efficiency of the tax system so that there is a level playing field for multinationals and domestic firms.

PE avoidance

Summary of proposed rule

23. Where a DTA applies, New Zealand is only able to tax a non-resident on its income from sales to New Zealand customers if the non-resident has a PE in New Zealand. The discussion document proposed a rule to prevent non-residents from structuring their affairs to avoid having such a permanent establishment in New Zealand where one exists in substance.

24. The rule proposed in the discussion document would deem a non-resident to have a PE in New Zealand if:

- the non-resident supplies goods or services to a person in New Zealand;
- the non-resident is part of a multinational group with more than EUR €750m of consolidated global turnover;
- a related entity (either associated or commercially dependant) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about;
- some or all of the sales income is not attributed to a New Zealand PE of the non-resident; and
- the arrangement defeats the purpose of the relevant DTA's PE provisions.

General reaction

25. Submitters were not strongly opposed to a new PE rule in principle, with 2 submitters supporting the proposal (Oxfam and NZCTU) and the remainder mostly accepting the need (or inevitability) for some form of PE avoidance rule. However 7 submitters considered that we should not adopt any PE avoidance rule at this stage. These submitters argued that:

- The OECD's Multilateral Instrument (MLI)[3] includes a widened definition of a PE so any PE avoidance issues should be addressed under this. Alternatively, we should defer consideration of a PE avoidance rule until the impact of the OECD's BEPS measures has been determined (EY, AmCham, DEG, CA ANZ).

- The rule is unnecessary, as any current issues with PE avoidance can be addressed through our transfer pricing rules (NZLS, DEG, CA ANZ).

- The rule will apply to non-abusive transactions, is outside the OECD's BEPS initiatives, and will erode taxpayer certainty (CTG, NFTC, Deloitte).

26. In response to these submissions, we consider that:

- Where the widened definition of a PE in the MLI applies, a domestic PE avoidance rule would not be necessary. However the widened definition applies only under the MLI where both countries choose to adopt it. We are aware that most countries do not intend to adopt the widened definition under the MLI (including the US, the UK, and Australia). We note that the widened definition is being added to the OECD's model treaty, and we expect it to eventually be incorporated into most of our DTAs (including DTAs with countries that did not elect to adopt the widened definition under the MLI) as each DTA is bilaterally renegotiated. However it will be many years before all our DTAs are bilaterally renegotiated. Therefore a domestic rule is necessary now to address PE avoidance by taxpayers resident in these countries.

- The principles underlying transfer pricing and PE profit attribution, while similar, are not the same. The transfer pricing rules seek to determine an arm's length price for transactions between related entities. The PE profit attribution rules seek to determine what part of an enterprise's overall profit should be attributed to a PE in a particular country. The OECD guidance is clear that profit may still be attributable to a PE even after the correct application of the transfer pricing rules (depending on the circumstances). In addition, deeming a PE to exist will allow us to charge non-resident withholding tax on any royalties paid by the non-resident that relate to its New Zealand sales. This will not be possible under the transfer pricing rules. Accordingly application of the transfer pricing rules alone would not produce the correct amount of tax for New Zealand in many cases where a PE is being avoided.

- Our proposed PE avoidance rule is broadly consistent with the OECD's BEPS initiatives, as it should have a similar effect to the widened PE definition in the MLI. We recommend below some changes to our PE rule which should ensure it is better targeted at abusive transactions. Finally we acknowledge that the rule will reduce taxpayer certainty, which is undesirable. However we consider that this disadvantage is outweighed by the benefits of the proposed rule in terms of protecting the integrity of the tax system, fairness, revenue, and economic efficiency.

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[3] The *Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting*. The MLI is a multilateral convention which is intended to prevent DTAs from being used to facilitate cross-border tax avoidance. The MLI amends a large number of each signatory's DTAs at once, and so implements the OECD's recommended DTA changes much faster than a succession of bilateral negotiations could. New Zealand signed the MLI on 7 June 2017.

27. We therefore recommend proceeding with the introduction of a PE avoidance rule.

Threshold for the application of the new measures

28. The discussion document proposed that the PE avoidance rule would only apply to arrangements which defeated the purpose of the PE provisions in the applicable DTA. The explanation of this test in the discussion document focussed on the economic substance of the non-resident's activity in New Zealand, and particularly whether a PE would arise if the non-resident and its local New Zealand subsidiary were treated as a single entity.

29. A majority of submitters (EY, NFTC, DEG, Deloitte, CTG, CA ANZ, PwC, KPMG, Russell McVeagh) considered that this proposed PE avoidance test was too broad. They considered that it would widen the PE definition in substance rather than just prevent its abuse. They were also concerned that it could capture ordinary commercial arrangements and discourage foreign investment. Some submitters considered that the PE avoidance rule should either be targeted at abusive or artificial arrangements or should adopt the wording of the OECD's widened PE avoidance definition in the MLI (CTG, PwC, Deloitte, CA ANZ, DEG).

30. We agree with these submissions. We recommend that the rule be more narrowly targeted so that it does not apply to ordinary commercial arrangements, and so does not unduly discourage non-residents from doing business in New Zealand.

31. Submitters suggested two options for narrowing the scope of the rule:

- **Option 1:** Replace the current requirement that the rule defeats the purpose of the PE article in a DTA with a purpose of avoidance test. Under this new test, the rule would only apply if the relevant arrangement had a more than merely incidental purpose of tax avoidance. This would target the rule at avoidance transactions and align the rule with similar rules in Australia and the UK, each of which requires the taxpayer to have a purpose of avoiding tax. Because it is an express anti-avoidance rule, it would also be consistent with our DTAs. The rule would apply more broadly in the context of PE avoidance than our current general anti-avoidance rule[4].

- **Option 2:** Replace the PE avoidance rule proposed in the discussion document with the OECD's widened definition of a PE, which we would add to our domestic legislation as a standalone rule. The OECD's widened definition provides that a PE arises if a representative of the non-resident plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the non-resident. The widened definition also includes some supplementary provisions to counter particular avoidance strategies observed overseas. This rule is an objective test and it is the result of the OECD's BEPS Action Plan, which included a report on "Preventing the Artificial Avoidance of Permanent Establishment Status" (Action 7). As indicated by the title of the report, the purpose of the rule is to prevent the artificial avoidance of PE status under various BEPS strategies. The widened PE definition would apply in respect of a DTA regardless

[4] This is because the general anti-avoidance rule applies only if an arrangement both uses the relevant provisions in a way that is outside of Parliament's contemplation (the Parliamentary contemplation test) and has a more than merely incidental purpose of tax avoidance. The proposed PE avoidance rule would not incorporate the Parliamentary contemplation test. Instead it would only require that an arrangement had a more than merely incidental purpose of tax avoidance.

of whether the other country elected to adopt it under the MLI. This test would be more certain for foreign investors than option 1 and would replicate the OECD's recommended measure.

32. We consider that either option would be effective in addressing the PE avoidance arrangements we have seen in New Zealand. Accordingly adoption of either option would not affect the previously forecast revenue estimates for the measures. We would like to further evaluate the merits of the two options before recommending one.

Interaction with MLI

33. Several submitters questioned how our proposed PE avoidance rule would interact with the widened definition of a PE in the MLI. As noted above, some submitters considered that PE avoidance should be dealt with under the MLI (EY, AmCham, DEG, CA ANZ). Other submitters questioned how our domestic PE rule would work in relation to a DTA that included the MLI's widened PE definition, or considered that any domestic rule should be consistent with the OECD's BEPS actions (KPMG, CTG, NZLS, PWC).

34. There is merit in these submissions. The widened PE definition from the MLI should address PE avoidance, provided it is included in the relevant DTA. Accordingly it is not necessary for our domestic PE avoidance rule to apply where there is an applicable DTA that includes the MLI's widened PE definition. We also generally prefer to follow the OECD's approach where that is practicable.

35. Accordingly, we recommend that our domestic PE avoidance rule apply only in respect of DTAs that do not include the widened PE definition from the MLI (or an equivalent definition that is negotiated bilaterally).

Overriding DTAs

36. A majority of submitters considered that our PE rule should not override our DTAs (CTG, KPMG, CA ANZ, NFTC, NZLS, EY, Russell McVeagh, DEG). This is because DTAs are important to international trade, and New Zealand exporters also need to rely on them. Submitters also considered that we should not depart from the OECD's agreed BEPS measures, particularly where the country of the non-resident has declined to adopt the widened PE definition in the MLI.

37. The OECD's Commentary to the Model Tax Convention (the Commentary) states that, as a general rule, there will be no conflict between domestic anti-avoidance provisions and the provisions of a DTA. It also confirms that States are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that this should not be lightly assumed). In the present case, our first option for a PE rule is an anti-avoidance measure that only applies if there is a purpose of tax avoidance. Accordingly it should not conflict with New Zealand's DTAs in the vast majority of cases. The second option is also an anti-abuse measure however it functions as a black letter amendment to the terms of our PE articles. Accordingly we would like to further consider its consistency with our DTAs before deciding which option to recommend.

38. In either case we consider that the PE rule should expressly override our DTAs. This is to simplify the application of the rule. Otherwise it would be necessary to show that the application of the rule was consistent with a DTA in each particular case. This would be a time-consuming and resource intensive exercise. It would significantly undermine the practical effectiveness of the rule. We also note that both the UK and Australian PE avoidance rules override their DTAs.

39. We also consider that the PE rule should apply in respect of DTAs where the other country has elected not to include the widened PE definition from the MLI. The existing position is that anti-avoidance rules are generally consistent with DTAs. We do not consider that a country's decision not to adopt the widened PE definition in the MLI changes this principle. In particular, we do not consider that such a decision evinces a common intent that a DTA can now be abused by the taxpayer of either jurisdiction.

40. We note that in relation to the second option (which incorporates the OECD's widened PE definition into our domestic legislation), the widened PE definition will be added to the OECD's model tax treaty, and so represents what the OECD considers to be the current best practice. Countries may also not want to adopt such a provision multilaterally under the MLI, but may be happy to agree to such a provision in bilateral negotiations with New Zealand (such as Australia). Accordingly, the failure to adopt the widened PE definition under the MLI does not mean that they object to such a provision in their DTA with New Zealand.

Source rules

PE avoidance source rule

41. The rule proposed in the discussion document stated that an amount of income would have a New Zealand source if we had a right to tax the income under the PE or royalty article of a DTA. Only 2 submitters opposed this rule, on the basis that it was circular (CTG) and could result in a breach of our DTAs (EY). We do not consider there is any circularity to the proposal – the proposal will ensure that we are not prevented from taxing income under our domestic legislation where we have an agreed right to tax that income under our DTAs. Also, for this reason, the rule would never apply in contravention of our DTA rights.

42. We note the rule proposed in the discussion draft applied only in respect of income covered by the PE article and the royalty article of our DTAs. This was because we were only aware of issues with our domestic legislation in relation to these kinds of income. On reflection, we consider the rule should apply in respect of all types of income we can tax under an applicable DTA (e.g. interest, dividends, income from alienation of property, etc.). This is sensible because it ensures that we do not negotiate taxing rights under a DTA that we cannot exercise because of differences in the formulation of the source rules in our DTAs and our domestic law source rules. This is the same position which Australia takes under its DTAs, and the proposed rule already applies to all income covered by an article of our DTA with Australia. Since we are broadening our original proposal we should consult further with stakeholders as part of the generic tax policy process (GTPP).

Anti-avoidance source rule

43. The rule proposed in the discussion document provides that a non-resident's income would have a source in New Zealand (and therefore give us a domestic law taxing right) if it would have a New Zealand source, treating the non-resident's multinational group as a single entity. This would stop non-residents from dividing their activities between wholly-owned group members in order to prevent their income from having a New Zealand source.

44. Some submitters considered that this rule should not proceed in its current form (CTG, EY, CA ANZ, Russell McVeagh). They considered that it was unnecessary, as our existing source rules were already adequate. Submitters also considered that the rule was too broad and struggled to understand how it would work in practice. Two submitters noted that a more targeted rule could be more appropriate (CA ANZ, EY).

45. The rule was partly intended to address an existing technical issue with the source rules, and partly intended to prevent possible future attempts to circumvent the source rules. In light of submitters' concerns, we consider that the rule should be more narrowly targeted at the existing issues with the source rules. In particular, the rule should broadly provide that, where a group member carries on a non-resident's business in New Zealand, the non-resident is also deemed to carry on business in New Zealand to that extent. This will prevent non-residents from being able to avoid a New Zealand source for their income from sales to New Zealand customers by arranging for a wholly owned subsidiary to carry out their local business activities. If the rule applied, only the portion of the sales income that is attributable to the group member's activities in New Zealand would generally be taxable here.

Life insurance rules / FIF rules

46. Life insurance premiums can be used to shift income out of New Zealand. As such, the Income Tax Act denies a deduction for reinsurance premiums when the corresponding premium income is not taxable in New Zealand.

47. Life insurance can also be used as a type of investment savings. For this reason, the foreign investment fund (FIF) rules apply to life insurance policies owned by New Zealand residents.

48. New Zealand's DTAs typically preserve New Zealand's entitlement to tax insurance premiums whether or not a permanent establishment exists. However, under New Zealand's DTAs with Canada, Russia, and Singapore, New Zealand is unable to tax life insurance premiums if a resident of those countries does not have a permanent establishment in New Zealand. New Zealand's inability to tax life insurance premium income under these DTAs means that the rules denying reinsurance deductions and the application of the FIF rules may not work as intended when the premium is paid to a non-resident life insurer or reinsurer from these countries. Furthermore, non-resident life insurers who are residents of Canada, Russia, or Singapore, are able to receive an unintended tax advantage by being able to deduct life reinsurance premiums.

49. The discussion document proposed an amendment to the Income Tax Act to specifically provide that no deduction is available for the reinsurance of policies if the premium income on that policy is not taxable in New Zealand (including under a DTA). An amendment to the

definition of a FIF was also proposed to specifically provide that New Zealand residents are subject to the FIF rules in respect of any policies that are not subject to New Zealand tax under the life insurance rules or any applicable DTA.

50. Submitters argued that the life insurance proposals should not proceed as they represent an unfair and unilateral reconstruction of the tax treatment of life insurance premiums (KPMG, EY, Deloitte, CTG, CA ANZ). Submitters argued that during treaty negotiations with Canada, Russia, and Singapore, New Zealand must have either accepted to change its standard practice of taxing insurance premiums, or inadvertently made the change – neither reason providing sufficient justification for the proposals. The submitters considered that the correct approach would be for New Zealand to renegotiate the relevant provision with Canada, Russia, and Singapore.

51. Submitters also argued that the proposals unfairly penalise the reinsured party by placing a significant burden on them to have completeness of information regarding their insurer's place of tax residence and PE status in NZ (CTG and Deloitte). Should the proposals advance, Deloitte considers that appropriate grandparenting should be provided.

52. We agree with the submissions in part. We consider that the proposed reinsurance amendments are necessary to ensure that they apply as intended. These proposals will also ensure that life insurance businesses operating out of Canada, Russia, and Singapore will no longer benefit from more favourable tax treatment compared with those operating in New Zealand or other countries. However, we recommend that the FIF life insurance changes do not proceed as there is little revenue risk involved and a significant likelihood of accidental non-compliance under the proposed changes. This means that any life insurance policies issued in New Zealand by life insurers from Singapore, Russia, and Canada would remain exempt from the foreign investment fund rules.

Transfer Pricing

53. Transfer pricing rules guard against multinationals using related party payments to shift profits offshore by requiring these payments to be consistent with an arm's length/market price that unrelated parties would agree to. Chapter 5 of the discussion document outlined a package of proposals to strengthen the transfer pricing rules.

General reaction

54. Three submitters (CTG, EY, KPMG) considered the transfer pricing proposals were unnecessary as the existing transfer pricing rules were sufficient. We disagree as New Zealand's existing transfer pricing legislation would not allow us to fully implement the OECD's new transfer pricing guidelines (that were developed to combat BEPS) as it does not explicitly require transfer pricing practices to align with the actual economic activity (if this differs from the legal contracts) and does not include a reconstruction provision.

55. Other submitters generally accepted that there was a need to update New Zealand's transfer pricing legislation so it aligns with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. However, as expected, there was strong opposition to the

administrative proposals to extend the time bar for transfer pricing adjustments to 7 years and to shift the burden of proof onto the taxpayer for providing evidence that they comply with the transfer pricing rules.

Extending the time bar to 7 years

56. Inland Revenue currently has 4 years from the end of the tax year in which a taxpayer files an income tax return to investigate and amend the tax position taken by the taxpayer in their return. This 4 year limit is known as the time bar. The discussion document proposed that transfer pricing issues should have a longer time bar of 7 years (consistent with fact that Australia and Canada have 7 year time bars for transfer pricing).

57. Eight of the 15 submitters (CTG, PwC, KPMG, CA ANZ, EY, AMP (NZ), Russell McVeagh, NFTC, DEG, NZLS) opposed this proposal. The main reasons for opposing a longer time bar were:

- A longer time bar increases uncertainty for taxpayers and does not promote efficiency in transfer pricing disputes (will delay timely resolution).
- The discussion document argued that a longer time bar is needed because transfer pricing issues are complex and fact-specific, but this is also true of other areas of tax such as tax avoidance, the capital/revenue boundary and complex financial arrangements.
- Most countries have the same time bar for transfer pricing and other tax issues, and in most cases this was less than 7 years.
- If a transfer pricing dispute is resolved in favour of Inland Revenue, the taxpayer will be at risk of double tax in jurisdictions where the time bar has already passed.
- Imposing a longer time bar is inconsistent with Inland Revenue's Business Transformation goals of real-time review and helping taxpayers get it right from the start.
- Inland Revenue should invest more resource into its transfer pricing team if the investigations are taking longer than 4 years.

58. Officials are not convinced by these arguments and consider there is still a good justification for extending the time bar to 7 years for transfer pricing issues. There are a number of reasons why transfer pricing investigations can take more time than other types of tax investigation:

- The factual review for transfer pricing cases is typically much more detailed than other tax issues and may involve discussions with numerous staff and the taxpayer, in addition to the usual review of legal documents etc. It may also involve wider industry interviews, e.g. with regulators, competitors, customers etc. to provide the necessary market context. The relevant documentation or information may be held outside New Zealand which can delay when this information is provided to Inland Revenue.

- Assessing compliance with the arm's length principle requires very detailed and specific information and analysis of how a comparable transaction between unrelated parties would have been conducted. This means there are effectively two parallel investigations – determining the facts of the actual related party transaction and identifying a comparable arm's length arrangement.

- Certain complex transactions require input from market experts typically based overseas. Vetting, engaging, and briefing an overseas expert takes time. Depending on the nature of the issues, the expert's opinion may also take some time to prepare.

- There is usually a range of possible answers in transfer pricing cases and this leads to more frequent and extensive discussions and negotiations throughout the process. Taxpayers generally wish to engage in discussions and negotiations (and exchange issues papers) prior to entering the disputes process. There are also often settlement discussions during the disputes process that can go on for many months at a time.

- There may also be numerous and lengthy discussions with treaty partners in the course of a transfer pricing investigation to not only obtain additional information but also endeavour to resolve differences without double taxation arising.

59. Currently, most transfer pricing investigations take less than 4 years and we expect this will continue under the proposed new rules. The longer time bar is therefore only expected to be relevant in a handful of complex cases. However, it is important to have more time available to identify, investigate and resolve these cases as they can involve very large sums of tax.

60. One concern with a longer time bar is that it could lead to more years of income being part of a dispute, which could reduce incentives for taxpayers and Inland Revenue to agree on a settlement to the dispute. However, Inland Revenue is increasingly picking up the vast majority of the arrangements it wants to challenge on a relatively real-time basis (often year two, taking into account filing timeframes which generally mean a return is not filed until the start of year two) which should lead to fewer years being under dispute.

61. New Zealand is adopting Article 17 of the MLI which will update our DTAs so that they require our DTA partners to make appropriate corresponding adjustments in transfer pricing cases. This will ensure that double taxation does not arise due to New Zealand making a transfer pricing adjustment, even if this is beyond the other country's time bar.

62. This also means that if New Zealand has a shorter time bar than other countries, we could be disadvantaged as we would be required to provide tax relief under our treaties, but would not be able to make tax positive adjustments in respect of those same years. In particular, Australia has a 7 year time bar for transfer pricing so New Zealand must provide up to 7 years of tax relief to Australian businesses, whereas we can only currently go back 4 years when adjusting the transfer prices of taxpayers that owe tax to New Zealand. Our DTA with Australia provides that both countries are allowed to propose transfer pricing adjustments up to 7 years after tax returns have been filed.

63. Having a longer time bar for transfer pricing does not preclude having shorter time bars in other areas where there is less risk or complexity. The discussion document noted that

Australia and Canada both have 7 year time bars for transfer pricing even though their standard time bars are 4 years. Australia also has a shorter 2 year time bar for individuals and small businesses. Therefore we consider that having a longer time bar for transfer pricing is not inconsistent with Inland Revenue's Business Transformation objectives.

64. Many submitters have suggested that as an alternative to extending the time bar, Inland Revenue should look to better resource its transfer pricing team. Inland Revenue may need to recruit a larger team of transfer pricing specialists to investigate transfer pricing issues. However, we do not agree that additional transfer pricing specialists would eliminate the need for a longer time bar. The longer time bar will only be necessary in a small number of complex cases. These cases require commissioning of overseas experts and multiple rounds of site visits, interviews and negotiations with taxpayers. These tasks are best performed by a small project team working in a logical sequence. Trying to use a larger team to simultaneously perform each task would be unlikely to shorten the overall time needed to resolve the dispute. Finally, it can be difficult for Inland Revenue to recruit or retain the relevant expertise as there is high global demand for transfer pricing experts.

Shifting the burden of proof from Inland Revenue to the taxpayer

65. The discussion document proposed shifting the burden of proof onto the taxpayer for providing evidence that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length.

66. This proposal is consistent with the fact that burden of proof is already on the taxpayer for other tax matters. Self-assessment is at the heart of how New Zealand's tax system works and helps encourage taxpayers to comply with the law and get it right from the start rather than having to subsequently amend their tax position as a result of an Inland Revenue investigation.

67. Four submitters (CTG, KPMG, CA ANZ, Russell McVeagh) argued that the burden of proof for transfer pricing should remain with Inland Revenue. The main arguments raised by submitters were:

- Shifting the burden of proof will increase compliance costs, especially in conjunction with the other transfer pricing proposals.

- Inland Revenue should provide more guidance on what transfer pricing documentation they expect to be prepared (or explicitly mandate for transfer pricing documentation to be prepared), rather than shift the burden of proof.

- The current ability for Inland Revenue to shift the burden of proof to the taxpayer when a transfer pricing position is undocumented is an effective way to encourage documentation.

- Inland Revenue may have better information on comparables than the taxpayer and should not be able to use secret information (that it cannot share with the taxpayer) to adjust a taxpayer's transfer pricing position.

68. The burden of proof is on the taxpayer for transfer pricing matters in most OECD and G20 countries, including Australia. This means most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries. For this reason, the additional compliance costs that would be imposed under New Zealand's transfer pricing rules from shifting the burden of proof onto taxpayers is not expected to be substantial.

69. When New Zealand's transfer pricing rules were introduced in 1995, most multinational transactions in New Zealand closely resembled easily observable market transactions. Two decades later, related party transactions and transfer pricing practices have become a lot more complex, specialised and sophisticated.

70. Multinationals typically have better information than Inland Revenue on market prices in their industry and on their supply chains. For this reason they are better placed to identify a relevant uncontrolled comparable and apply the arm's length principle.

71. One submitter (KPMG) suggested the legislation should explicitly mandate the type of transfer pricing documentation that taxpayers have to prepare as an alternative to shifting the burden of proof. Others (EY, PwC, AmCham) suggested that Inland Revenue should prepare additional guidance on what documentation would be required to satisfy the burden of proof.

72. We consider that taxpayers are best placed to consider the amount of documentation or evidence that is required to demonstrate compliance (as this will vary based on the tax effect or materiality of the transaction). Imposing a minimum standard for documentation could impose additional compliance costs in respect of lower-risk transactions (which may require no or little documentation) and may not lead to adequate documentation for higher-risk transactions (which should require a higher standard to discharge the burden of proof). The OECD has recently issued extensive international guidance on transfer pricing documentation, which New Zealand endorses, and Inland Revenue has issued some short supplementary guidance as well.

73. Three submitters (CTG, KPMG, Russell McVeagh) raised concerns that Inland Revenue could potentially use information that it held on comparable transactions to adjust a taxpayer's transfer pricing position and then not share this information with the taxpayer on the ground that it was tax secret. They considered this was a reason why the burden of proof should remain with Inland Revenue (either more generally, or just in this particular scenario).

74. However, in the 22 years since the transfer pricing rules were introduced, Inland Revenue has never used a secret comparable to adjust a taxpayer's transfer pricing position. In practice, because New Zealand is a small market, Inland Revenue mainly sources comparable information from commercial databases that can also be purchased/accessed by taxpayers (as opposed to its own tax information). In any case, if Inland Revenue did in fact ever make an adjustment based on information that was not accessible to the taxpayer, it would be able to anonymise the relevant information in order to share the basis for the adjustment with the affected taxpayer.

The test for reconstructing a transfer pricing arrangement

75. Consistent with Australia's rules and the OECD's transfer pricing guidelines, the discussion document proposed providing Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to.

76. Two submitters (TPEQ and Russell McVeagh) argued that New Zealand should not include a specific reconstruction rule in our transfer rules as New Zealand's existing general anti-avoidance rule already allows the Commissioner to challenge and reconstruct tax avoidance arrangements. We note that the general anti-avoidance rule would be more difficult to apply as it requires an explicit purpose of tax avoidance, whereas the proposed rule (and the OECD's transfer pricing guidelines) would not. Therefore, we consider that a specific transfer pricing reconstruction rule is still necessary.

77. Eight of the 15 submitters (CTG, KPMG, TPEQ, CA ANZ, EY, PwC, AMP (NZ), Deloitte) raised concerns about the potentially broad scope of the proposed reconstruction rule and submitted that the proposed reconstruction rule should only apply in the "exceptional circumstances" described in the OECD's transfer pricing guidelines.

78. The discussion document proposed that we adopt Australia's provision which allows transfer pricing arrangements to be reconstructed when: *"independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations."*

79. Australia's rule was developed in 2012 before the OECD's new transfer pricing guidelines were published in 2015. The OECD guidelines suggest that tax authorities should only reconstruct those arrangements that: *"differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties..."*

80. Although Australia's test is intended to be applied on a consistent basis to the test in the OECD's transfer pricing guidelines, Australia's wording is potentially broader, which creates uncertainty for taxpayers. Unlike the OECD's transfer pricing guidelines, it doesn't explicitly specify that the original arrangement should be commercially irrational to the extent that third parties wouldn't be able to reach such an agreement.

81. New Zealand endorses the OECD's transfer pricing guidelines. Therefore in order to provide more certainty for taxpayers, we recommend that New Zealand's legislative test for reconstructing an arrangement should be based on the corresponding test in the OECD's transfer pricing guidelines.

Administrative measures

Summary of measures

82. The discussion document proposed measures to help Inland Revenue investigate and assess un-cooperative multinationals. These included the following proposals:

- If a large multinational (over EUR €750m worldwide revenues) does not cooperate with Inland Revenue, then Inland Revenue may more readily issue a notice of proposed adjustment, and any subsequent documents under the disputes process, based on the information available to Inland Revenue at the time.

- Any disputed tax must be paid by a large multinational during the disputes process, rather than at the end of the final Court case. This only applies in respect of disputes over transfer pricing, the amount of New Zealand-sourced income, and the application of a DTA.

- Tax payable by any member of a large multinational can be collected from any wholly-owned group member (or the related New Zealand entity in case of the new PE avoidance rule).

- Inland Revenue will be empowered to collect more information from large multinationals, including information about its various non-resident group members. If the multinational does not provide the information, then penalties may be payable and Inland Revenue will be expressly authorised to assess the taxpayer based on the information available to it.

General reaction

83. Submitters were generally accepting of some form of administrative measures in relation to uncooperative multinationals.

84. Submitters did note that any legislation needed to make it clear when the measures applied, and there needed to be sufficient safeguards (both in terms of legislative requirements and Inland Revenue's internal processes) to ensure the measures were not misapplied (KPMG, PwC, TPEQ, AMP (NZ), Russell McVeagh, NFTC, DEG). Some submitters also stated that the rules should be narrowly targeted (CTG, NZLS, DEG, NFTC, PwC), while others called for an increase in Inland Revenue's resources to help taxpayers comply with the new BEPS measures (EY, CA ANZ, PwC). We note these concerns and will consider them when we design the detail of the measures.

Earlier payment of disputed tax

85. Submitters strongly opposed the proposal to advance the time at which multinationals must pay any tax in dispute (KPMG, EY, Russell McVeagh, NFTC, DEG, NZLS, AMP (NZ), CTG). Some submitters argued that the proposal to make large multinationals pay disputed tax upfront was unnecessary. This was because Inland Revenue already charges "use of money interest" on tax owing, which provides a strong incentive for multinationals to pay any tax that is in dispute. In addition, the "use of money interest" paid by Inland Revenue to

taxpayers on tax that is paid, but not legally owed, is significantly below market rates. This could unduly pressure taxpayers to settle.

86. We agree with the views of submitters. The proposal was based on similar rules in Australia's and the UK's diverted profits taxes, and was intended to disincentivise taxpayers from deliberately prolonging disputes. However in light of the current "use of money interest" rates, we consider the rule is not necessary, and may instead unduly pressure taxpayers to settle. In addition such a rule appears better suited to a diverted profits tax regime, which is intended to incentivise taxpayers to pay the correct amount under the ordinary income tax rules. It seems less appropriate to include it in the ordinary income tax rules themselves.

87. Accordingly we recommend that you do not proceed with the proposal.

Collection of tax from a local subsidiary

88. Some submitters opposed the proposal to allow tax owing by a non-resident to be collected from a wholly owned subsidiary in New Zealand (or the related entity where the proposed PE avoidance rule applies) (CTG, PwC, Russell McVeagh). They questioned the practical need for such a rule, noted that it undermined the separate legal identity of corporate subsidiaries, and were concerned that it could cause risk assessment and banking covenant issues for lenders. One submitter (PwC) noted that if the rule was to proceed, it should apply only where the non-resident did not pay.

89. We consider that such a rule is useful to allow the collection of tax from non-residents with no direct presence in New Zealand. We also think it is reasonable to apply the rule where the non-resident and the New Zealand subsidiary are part of the same wholly-owned group, as they are part of a single economic entity.

90. Accordingly we recommend that the rule be retained. However we agree that the rule should only apply if the non-resident fails to pay the tax itself, and if the non-resident and the New Zealand entity are part of the same wholly-owned group. This should mitigate some of the submitters' other concerns about risk assessment and banking covenant issues.

Collection of information

91. A majority of submitters considered that the information collection powers should not proceed (CTG, Russell McVeagh, PwC, NZLS, NFTC, AMP (NZ), AmCham, DEG). Submitters variously considered that the rules were unnecessary in light of enhanced international information sharing protocols (such as country-by-country reporting), would be unworkable in practice, and unfairly penalised the New Zealand resident, who may not be able to get the information from their multinational group members. Some submitters also considered the issue should be addressed by Inland Revenue improving its relationship with other tax authorities (AMP (NZ), Russell McVeagh, AmCham, DEG, NZLS).

92. Submitters raised further concerns about the new civil penalty of up to $100,000 for failing to provide requested information (which replaces the current $12,000 maximum criminal penalty) (CTG, CA ANZ, Russell McVeagh, PwC, NFTC, NZLS). Submitters considered the penalty should not be increased, given that the New Zealand subsidiary may

not control the relevant information. If the penalty was to apply, they considered that only a court should be able to apply it. Finally they considered that directors and company employees should not be liable for the penalty personally.

93. We recommend that the information gathering proposals proceed (with some changes), notwithstanding submitters' views. In our view it is unacceptable for Inland Revenue investigations to be frustrated because a multinational group fails to provide information that is under its control.

94. We do not think the New Zealand subsidiary's difficulty in obtaining the information is a valid objection to the proposals. The New Zealand subsidiary is simply part of the multinational's economic group. Therefore any consequences suffered by the New Zealand subsidiary are economically borne by the wider group and its shareholders. Accordingly our proposed measures effectively make the entity which controls the information liable for the economic consequences of its failure to provide that information.

95. Further, the inability of the New Zealand subsidiary to legally require the information to be provided is the reason the proposed measures are necessary in the first place. There must be incentives for the multinational group to provide Inland Revenue with the required information in the absence of any legal ability to compel its provision. This means that any failure to provide the necessary information must be to the multinational's detriment, not Inland Revenue's. Otherwise multinationals will be incentivised not to provide such information.

96. In relation to submitters' other points:

- The information shared under new international protocols, such as country by country reporting, is at a more general level and will not be sufficient for Inland Revenue to assess particular taxpayers. In fact, tax authorities are explicitly prohibited from using country-by-country reports as a basis for assessing taxpayers.

- We are committed to improving our relationship with other tax authorities, but this will not practically address the current issue. The required information may not be held by the other tax authority, or it may be slow to obtain it.

- The impracticality of a New Zealand subsidiary obtaining the required information from another group member seems to be caused by the internal processes and priorities of the multinational group. This impracticality may ameliorate once the inability to obtain the information starts having negative consequences for the group. In the event that it does not, it should be the multinational that bears the negative consequences arising from its own processes and priorities, rather than Inland Revenue.

- Inland Revenue should be able to charge the penalty for not providing information, without requiring court approval. This is the normal position for civil penalties under the Tax Administration Act 1994 and we do not see why an exception should be made here. Further, such a requirement would also significantly undermine the practicality of imposing the penalty, and it is difficult to see what additional benefit it would provide. We also note that Australia has recently introduced a similar

penalty, with a maximum amount payable of $450,000. However we agree that taxpayers should be able to challenge the penalty once it is applied (in common with other similar penalties). We will ensure this is provided for when we design the detail of the measures.

- We agree that the penalty should not apply to directors or employees of a company. We will clarify this when the detail of the rule is designed.

97. We also want to ensure that the proposed information gathering powers and penalties are used by Inland Revenue in a reasonable manner. Accordingly we will consider ways to ensure this is the case when we design the rules in more detail.

Application date and grandparenting APAs

Application date

98. The planned application date for these measures is the income year starting on or after 1 July 2018.

99. At the time the discussion document was released for public consultation, the planned application date was not publicly known.[5] For this reason, Inland Revenue has not received any submissions on the 1 July 2018 application date. However, some submitters expected the Government to seek an early application date and argued that it would be better to allow taxpayers time to consider the proposals and rearrange their affairs if necessary (PwC and CTG). PwC argued that the application date for these proposals should be no earlier than the first income year after 31 March 2019.

100. Cabinet has already noted that the reforms are expected to apply from income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is based on the expectation that the legislation will be progressed to enactment before this date.

101. We expect to receive more submissions on, and opposition to, the application date once the public becomes aware it is proposed to be 1 July 2018.

Grandparenting APAs

102. A taxpayer is able to apply for an advance pricing agreement (APA), which is essentially a binding ruling confirming that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years. Some submitters argued that existing APAs should be grandparented and allowed to run their course (PwC and CTG). This would reduce any uncertainty taxpayers may face in light of the changing environment. Without grandparenting, taxpayers may be disincentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.

103. We agree with this submission. There is a high cost and a rigorous process involved in obtaining an APA and it would be unfair if the new proposals rescinded APAs issued before the 1 July 2018 application date – especially considering APAs only run for five years.

104. We therefore recommend grandparenting all APAs existing prior to the 1 July 2018 application date.

Appendix One: List of submitters

Abbreviation	Full name	Description	IL[6]
AmCham	The American Chamber of Commerce in New Zealand	AmCham is a New Zealand business organisation which promotes two-way trade and investment relationships primarily between New Zealand and the United States, but also within the Asia-Pacific region.	✓
AMP (NZ)	AMP Capital New Zealand	AMP is a specialist investment manager that manages a number of Portfolio Investment Entity funds, as well as private equity investments.	✓
CA ANZ	Chartered Accountants Australia and New Zealand	Chartered Accountants Australia and New Zealand is the incorporated body representing the Institutes of Chartered Accountants in Australia and New Zealand. CA ANZ represents over 100,000 members in Australia, New Zealand, and overseas.	✓
CTG	Corporate Taxpayers Group	CTG represents 40 large New Zealand corporates and also include tax advisors from Deloitte, Russell McVeagh, and OliverShaw.	✓
DEG	Digital Economy Group	DEG is an informal coalition of leading US and non-US software, information/content, social networking, and e-commerce companies that provide goods or services through digital and non-digital means.	
Deloitte	Deloitte	Deloitte New Zealand is an accounting firm providing audit, tax, consulting, enterprise risk, and financial advisory services.	✓
EY	Ernst & Young	EY New Zealand is a professional services firm which specialises in assurance, tax, transaction and advisory services.	✓
KPMG	KPMG	KPMG refers to the New Zealand arm of KPMG International – the global network of professional firms providing audit, tax, and advisory services.	✓
NFTC	National Foreign Trade Council	NFTC is an association of approximately 250 United States business enterprises engaged in all aspects of international trade and investment.	
NZCTU	New Zealand Council of Trade Unions Te Kauae Kaimahi	NZCTU is one of the largest democratic organisations in New Zealand. NZCT is made up of 30 unions and has 320,000 members.	✓
NZLS	New Zealand Law Society	NZLS controls and regulates the practice of the law profession in New Zealand. The NZLS also assists and promotes law reform for the purpose of upholding the rule of law and the administration of justice.	✓
Oxfam	Oxfam New Zealand	Oxfam is a world-wide development organisation that mobilises the power of people against poverty.	✓

[6] Submissions also received on *BEPS – strengthening our interest limitation rules*

		Oxfam NZ is the New Zealand arm of the global organisation.	
PwC	PwC	PwC refers to the New Zealand arm of PwC International – a multinational professional services network which advises on tax.	✓
Russell McVeagh	Russell McVeagh	Russell McVeagh is a New Zealand commercial law firm with offices in Auckland and Wellington.	✓
TPEQ	TP Equilibrium | AustralAsia	TPEQ is a boutique transfer pricing advisory firm which covers numerous industries for both the Australian and New Zealand markets.	✓

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

RECEIVED

6 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS - Recommendations on addressing hybrid mismatch arrangements

Date:	22 June 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1604 IR2017/353

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations in this report	29 June 2017
Minister of Revenue	**Agree** to the recommendations in this report	29 June 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Steve Mack	Principal Advisor, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Matthew Gan	Tax Specialist, The Treasury	
Paul Kilford	Policy Manager, Inland Revenue	
Casey Plunket	Special Policy Advisor	

22 June 2017

Minister of Finance
Minister of Revenue

BEPS - Recommendations on addressing hybrid mismatch arrangements

Executive summary

1. This report seeks your:

- agreement to detailed proposals for reforming the taxation of hybrid and branch mismatch arrangements, which implement in a New Zealand context Action 2 of the OECD Base Erosion and Profit Shifting ("BEPS") programme ("hybrid proposals"); and
- approval to prepare a paper requesting Cabinet's agreement to include the hybrid proposals in a BEPS tax bill.

Development of recommendations to date

2. On 6 September 2016, the Government released a discussion document seeking feedback on proposals to address hybrid mismatch arrangements (T2016/1319 IR2016/342 refers). Broadly speaking, these are cross-border arrangements where the application of different countries' tax rules results in either temporary or permanent non-taxation of income. Action 2 of the OECD BEPS Action Plan consists of recommendations for countries to address these arrangements. The discussion document proposals are closely modelled on the OECD recommendations as set out in its Final Report "Neutralising the Effects of Hybrid Mismatch Arrangements".

3. On 9 March we reported to you on submissions in response to this document, and sought your approval to undertake further consultation (T2017/406 IR2017/133 refers). We also sought your approval for that further consultation to include consultation on branch mismatches, which are closely related to hybrid mismatches and in relation to which the OECD has developed a report (the "Branch Report") with recommendations closely based on the hybrid mismatch recommendations. The draft branch report was published in August 2016 and the final branch report is expected to be available shortly.

4. We have now completed the further consultation. We have engaged in approximately a dozen workshops (with Corporate Taxpayers Group and Chartered Accountants Australia New Zealand) and attended various other meetings with private sector submitters (including

the New Zealand Bankers' Association). The consultation process was useful and we have made a number of changes to the proposals in the discussion document to take into account the concerns of submitters.

5. In particular, we have given careful consideration to the position of New Zealand businesses with foreign branches, to ensure that the proposed hybrid rules do not deny these businesses the ability to use any foreign branch losses in New Zealand except where there is a high likelihood of double non-taxation.

6. We have also consulted on the hybrid rules with counterparts in Australia and the United Kingdom, as well as the OECD secretariat, to ensure that the rules we propose work as intended, and do not give rise to inadvertent double taxation or non-taxation. Our proposals are very similar to Australia's hybrid proposals. We note in this report any significant points on which we are aware of a difference.

Budget 2017 decision on foreign hybrid entity double deductions

7. As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand (CAB-17-MIN-0164 refers). This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions. It is intended to come into force as part of the general hybrid rules dealt with in this report. Nothing in this report is inconsistent with that decision.

Format of this report

8. This report first provides a summary of the hybrids issue, the OECD solution, and officials' recommendation that New Zealand should implement that solution. The most significant issues arising from the recommendations of this report are separately commented on starting at paragraph 23.

9. The main body of the report goes through the OECD recommendations in numerical order. It discusses the general principles of each recommendation (or recommendations where they can logically be grouped) and then runs through a series of more detailed decisions that are consequential to the relevant principle. We consider these details will be important in creating a package that effectively counteracts the tax advantages of hybrid arrangements. There are some technical issues that we consider would still benefit from more consideration by officials before final decision are made. We have highlighted these areas both in the recommendations and in the body of the report.

10. We have included two appendices which are respectively a tabulated overview of the OECD recommendations and a glossary of some of the technical terms of this report.

Policy proposals

The issue: hybrid mismatches

11. The objective of the OECD hybrid rules is to prevent double non-taxation which arises because countries tax entities or arrangements in different ways. Broadly speaking, this double non-taxation can arise because:

- A payment is deducible to the payer in one country but not taxable to the payee in another country, if the reason for the mismatch is a conflict in tax rules. For example:
  - The tax rules applying to a corporate payee may treat the payment as a dividend on a share (which in many countries is exempt if the payer is a foreign company related to the payee), even though the tax rules applying to the payer in its home country treat it as interest on a loan. This is a hybrid financial instrument mismatch, and is dealt with in OECD recommendations 1 and 2;
  - The tax rules applying to the payee may treat the payer and the payee as a single taxable entity. An example of this is where a New Zealand unlimited liability company makes a deductible payment to its 100% US parent company. Under US tax rules, the New Zealand company can be treated as a branch of the US company, and therefore payments by the New Zealand company are disregarded for US tax purposes and so are not taxable. In this case the New Zealand company is a hybrid entity and the mismatch is dealt with by OECD recommendation 3; or
- A single payment is deducted against different income in two countries. An example is where a company with a tax loss is treated as tax resident both by New Zealand and another country. Suppose that the company has a profitable sister company resident in New Zealand, and another profitable sister company in the other country. If the loss can be grouped against the income of the sister company in both New Zealand and the other country, then the loss has been used twice, which means the group has been taxed on less than its full amount of net income. This is a dual resident company mismatch, and it would be dealt with by OECD recommendation 7.

12. Double non-taxation of this kind is difficult to deal with, because it arises even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues.

The OECD Action 2 response

13. It is not feasible for all countries to have identical tax rules. Accordingly the only way to avoid double non-taxation of the kind referred to above is for countries to take a "tax without borders" approach by adopting, for cross border arrangements, tax rules which take into account in some way the tax rules of the other country involved. The OECD recommends two kinds of rules. The first kind are rules to reduce the likelihood of such mismatches arising. The second are "linking rules", which apply only to arrangements

between related parties (25% or more commonly owned) or structured arrangements (generally, arrangements between non-associated parties which intentionally exploit such mismatches). These linking rules apply to situations when there is a mismatch which has not been prevented by any other domestic rules, and provide for a primary and defensive response to the mismatch. This is explained further below.

14. The OECD hybrid recommendations are as follows:
   - recommendation 1 deals with D/NI (deduction/no inclusion) payments under hybrid financial instruments which are either structured or between related parties;
   - recommendation 2 deals with deductible dividends, which can also produce a D/NI outcome;
   - recommendation 3 deals with D/NI payments by a branch or a hybrid payer entity to a person in the same control group (50% or commonly owned). A hybrid entity is treated as a separate person under its own tax rules, but disregarded/transparent under the rules of the payee country;
   - recommendation 4 deals with deductible payments to a reverse hybrid in an arrangement which is either structured or between members of a control group (a reverse hybrid is an entity which is transparent for tax purposes in its own country but treated by an owner as a separate entity);
   - recommendation 5 proposes modifications to the existing domestic law rules to prevent reverse hybrid mismatches being available;
   - recommendation 6 deals with payments by branches or hybrid entities which are deductible in two countries;
   - recommendation 7 deals with payments by dual resident companies which can be deductible in two countries;
   - recommendation 8 deals with imported mismatch payments, which are ordinary payments that can be regarded as funding hybrid mismatch payments in the same group that do not directly impact on New Zealand;
   - Recommendations 9-12 support the earlier recommendations, and relate to design and definitions.

15. An overview of the recommendations (with description and proposed counteraction) is in Appendix 1.

Submissions on the hybrids discussion document and our response

16. In our previous report, we noted that while most submitters accepted the need for some hybrid rules, they also advocated a targeted or phased approach to New Zealand's implementation of the OECD hybrids package, focussing on countering arrangements of the most concern to New Zealand.

17. On balance, we are not convinced by these submissions, and recommend implementing the full suite of OECD rules, subject to modifications summarised below. We note that some of the rules only require minor legislative amendment, as they are already part of our law.

18. The reasons for making this recommendation are set out fully in our report on submissions. In summary, we believe that enacting the OECD rules will:
   - improve fairness;

- reduce harmful distortions in investment patterns; and
- have a negligible effect on the cost of capital in New Zealand, particularly given the adoption of the rules by the UK, Australia and the EU;
- (as compared to a partial adoption)
  - avoid the need for further piecemeal amendments
  - avoid giving the appearance of blessing those mismatches not dealt with;
- involve acceptable compliance costs, particularly given
  - the expectation that the effect of the rules in most cases will be to drive taxpayers to simpler non-hybrid arrangements (an important exception is branch structures, which are discussed in detail in this report);
  - the adoption of similar rules by other countries.

19. It is also important to appreciate that tax avoidance and tax planning using a range of hybrid structures is well known in New Zealand.

- The bank conduit cases (*Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 and *BNZ Investments Ltd v CIR* (2009) 24 NZTC 23,582), the optional convertible note structures (see *Alesco New Zealand Ltd v CIR* (2013) 26 NZTC) and certain mandatory convertible note disputes are all examples of hybrid financial instruments, the subject of OECD recommendations 1 and 2. While they were all held to be ineffective under the general anti-avoidance provision, the process to get to that point was often protracted and economically inefficient. Hybrid rules would have made these transactions clearly tax-ineffective, and they would not have occurred if we had such rules;
- Arrangements are currently in place which exploit hybrid mismatches but are not generally subject to the general anti-avoidance provision. Examples are:
  - The deductible/frankable instruments issued by Australian owned banks out of New Zealand – again these are hybrid financial instruments subject to OECD recommendations 1 and 2;
  - Financing through Australian limited partnerships, which generate double deductions – this is an example of a hybrid payer mismatch subject to OECD recommendation 6;
  - Investment into New Zealand using New Zealand incorporated companies with unlimited liability. Unlimited liability companies can be treated as transparent for US tax purposes, leading to deduction/no inclusion mismatches dealt with under OECD recommendation 3;
- Going further back, New Zealand has also experienced tax planning using dual resident company double deduction arrangements, subject to OECD recommendation 7. As a result we now have provisions which deal with most, but not all, of the hybrid mismatches which can arise from dual resident companies.

20. Mismatches that we are not aware of being used more than rarely are structures that use:

- payments to reverse hybrids subject to OECD recommendation 4, although under current settings there is no particular reason for Inland Revenue to look for them;
- reverse hybrid entity mismatches to achieve double non-taxation of outbound investment (which would be subject to OECD recommendation 5.1);
- imported mismatches (subject to OECD recommendation 8), where funding is channelled into New Zealand using a structure where there is a hybrid mismatch occurs higher up the funding chain, in a transaction not directly involving a New

Zealand taxpayer. We are aware of one such structure and there may be more since, under current settings, there is no particular reason for Inland Revenue to look for them;
- branch mismatches other than those subject to recommendation 6.

21. Despite the fact that not all the types of mismatches dealt with in the OECD Report are currently seen in New Zealand, we consider that given the history touched on in paragraph 19, it is likely that some of the hybrid mismatches that are not addressed in New Zealand's response will be exploited at some point in the future. Addressing everything comprehensively now means the process of amending the legislation will be a very large and complex project that will have to be undertaken alongside the other BEPS projects in a relatively short timeframe. However, as stated above, on balance officials recommend implementing a comprehensive set of hybrid rules.

22. As will be evident from this report, the hybrid rules are complex, and require amendment to many aspects of our tax law. It is important to emphasise that for the vast majority of businesses they should have no impact whatsoever. The hybrid rules will have no impact on purely domestic firms owned by New Zealand residents. Even of those firms that are international, most do not enter into hybrid arrangements directly with New Zealand. Those who do have mostly done so because of the existing tax benefits. Once those benefits are removed, they will likely revert to much simpler and less costly structures. Where application of the rules is unavoidable, for example in relation to New Zealand businesses with foreign branches, we have paid particular attention to simplicity and compliance costs.

Significant issues

23. In this section we have highlighted the recommendations which are likely to attract most comment from submitters, and are therefore significant for more than merely technical reasons.

Application of hybrid rules to foreign branches

24. Particularly in the course of our recent workshop consultations, submitters were very concerned about the fact that the hybrid rules can deny a New Zealand company the ability to reduce the tax on its New Zealand income by offsetting against that income the loss from a foreign branch.

25. We have made various modifications to the OECD proposals to address this issue, including ensuring there is clearly no loss denial for taxpayers who have not entered into more complex structures. However, these modifications may not be to the satisfaction of all in the business or advisory community. In particular, some submitters wanted a de minimis rule of some sort, but we consider our suggested modification to make it clear that simple structures are not impacted by the hybrid rules makes this unnecessary.

Application of hybrid rules to foreign trusts

26. We recommend that the hybrid rules should apply to income of a New Zealand trustee of a foreign trust. This may make it less attractive for New Zealand residents to act as trustees of trusts with non-resident settlors and non-resident assets.

27. As a result of the recommendations of the 2016 Government Inquiry into Foreign Trust Disclosure Rules (Shewan Report), foreign trusts with New Zealand trustees have recently been required to comply with new and more thorough registration and disclosure requirements. This is likely to lead to a significant diminution in the number of such trusts, but we expect there will still be a sizeable number in existence – the number will not be known until 30 June, which is the due date for the new registrations.

28. It is likely that the foreign trust service providers will object to foreign trusts being subject to the hybrid rules. This could be on:

- a technical basis; and/or
- the basis that they have now spent the time and effort to become fully compliant with internationally best-practice disclosure requirements. They may argue it would be unfair for the Government to then make a substantive tax change which for many would make their efforts redundant.

29. We have outlined two options to address the potential hybrid mismatches arising from foreign trusts in paragraphs 123 to 128 below.

Imported mismatches

30. The OECD recommends that countries include imported mismatch rules. These deny a deduction for a payment which is not directly a mismatch between the New Zealand payer and the payee, but which funds the payee (or a higher level "payee") to make a payment in a hybrid mismatch to a person not directly transacting with the New Zealand taxpayer. Many submitters viewed this as over-reach, highly complex and impractical.

31. We have responded to these submissions by recommending that the imported mismatch rule be enacted in full, but that its implementation be partially deferred.

- When the payment from New Zealand is part of a structured arrangement which includes a hybrid mismatch, applying the imported mismatch rule is both more straightforward and more important to the integrity of the rules. We recommend that this structured aspect of the rule be implemented along with the rest of the hybrid rules.
- When the payment from New Zealand is not part of a structured arrangement, applying the rule is more difficult and less important to the integrity of the New Zealand rules. Delaying the implementation of this rule until there are more countries that have hybrid rules would be sensible. We suggest a delay until 1 January 2020, by which date the EU countries, the UK, and Australia should all have hybrid rules.

Over-taxation by reason of the imposition of NRWT

32. There is no doubt that if a deduction is permanently denied under the hybrid rules for a payment where New Zealand also imposes non-resident withholding tax, there is an element of over-taxation.

33. The OECD does not recommend any adjustment be made to prevent this over-taxation. The UK has followed this approach, though it does not apply withholding tax as widely as New Zealand. Australia has not shown any interest in departing from the OECD approach. Accordingly, there are strong precedents for not addressing this issue.

34. This approach can be justified on the basis that in the majority of cases there should be simpler alternatives to hybrid arrangements giving rise to NRWT. Furthermore, in the case of hybrid financial instruments, if the payee country adopts recommendation 2, there will be no denial under recommendation 1, and therefore no over-taxation. This is expected to resolve the issue in most cases where a New Zealand taxpayer makes a payment under a hybrid financial arrangement to an Australian payee.

35. Nevertheless, we recommend that in the case of a hybrid financial instrument denial, we consider whether taxpayers could be permitted to treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We need to give further consideration to the flow on effects of this recommendation.

36. This recommendation is likely to go some way to addressing submitters' concerns on hybrid financial instruments, if upon further consideration the measure proceeds. However, they may still be concerned about the treatment of other non-deductible amounts.

Grandparenting for certain instruments issued by banks to the public

37. Generally the hybrid rules will apply to income and deductions arising after the effective date (expected to be some time on or after 1 July 2018), without regard to when the arrangement giving rise to that amount was entered into. This is the OECD recommendation, which was followed by the UK, and is proposed in the EU and Australia.

38. We recommend an exception for certain hybrid instruments ("regulatory capital hybrids") issued by banks and insurance companies either directly or indirectly to third party investors, mostly in Australia, in partial satisfaction of the capital requirements imposed on those companies by regulators. We recommend that instruments issued before the discussion document was released (6 September 2016) should not be subject to the hybrid rules until after the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

39. No special treatment was proposed for such instruments in our discussion document. However, we received submissions that such instruments either should not be subject to the hybrid rules at all, or that if they were so subject, there should be some grandparenting relief. Generally the latter submission was based on the publicly issued nature of the instruments. Mostly, the hybrid rules only apply to arrangements between parties who are related or in the same group.

40. Australia announced that it would apply the hybrid rules to such instruments on its Budget day this year. For that reason, it has decided to grandparent regulatory capital instruments issued before 8 May 2017.

Withheld under section 9(2)(b)(ii) of the Official Information Act 1982

[redacted]

Opaque election for foreign hybrid entities

42. The private sector has proposed that New Zealand investors in foreign hybrids be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand. This would mean the New Zealand tax treatment would match the company treatment overseas. This opaque election would take the entity outside the scope of the rules and achieve roughly the same tax effect with lower compliance costs.

43. This opaque election regime, if included in the rules, is most likely to be used by an Australian limited partnership, which is treated as flow-through by New Zealand such that its income and expenditure is attributed to its partners.

44. Administratively, this would likely require some sort of declaration made to the Commissioner. Our current thinking is this declaration would be irrevocable and would continue to apply in the event of a change of ownership. Officials are still working through the details of this idea and whether to recommend its inclusion in the rules. If it does not form part of the final package, this may be viewed unfavourably by the private sector.

Application of rules to branch mismatch arrangements

45. Taxpayers may be concerned to hear that "branch mismatches" are subject to the hybrid rules, since branches are relatively common for a business to have. Accordingly it may be important to be clear about the limits of branch mismatches.

46. Branch mismatches arising from foreign branch losses are a double non-taxation risk. The remainder of the branch mismatch concerns are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

De minimis rule

47. Officials are not recommending a general de minimis for the hybrid rules. The reason for this is that we are comfortable that the proposals will ensure that simple offshore branch structures are not within the scope of the rules. In addition, a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules.

48. However, officials have provided for a specific de minimis-type rule for reverse hybrid entities established in New Zealand (likely to be limited partnerships and foreign trusts).

Recommended action

We recommend that you:

(a) **Agree** that a Cabinet paper should be prepared recommending that the general principles of proposals to counteract hybrid mismatches in line with the recommendations in the OECD *Neutralising the Effects of Hybrid Mismatch Arrangements* report are drafted into a bill, subject to the modifications and further detail contained in this paper.

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** that the Cabinet paper in recommendation (a) should delegate authority to the Minister of Finance and the Minister of Revenue for the detailed design relating to the general principles of the hybrid mismatch arrangements rules discussed in the recommendations below.

Agreed/Not agreed Agreed/Not agreed

OECD recommendations 1 and 2: general principles

(c) **Agree** the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principles in accordance with OECD recommendations 1 and 2:

a. In relation to a payment under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:
   (i) deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (recommendation 1 primary rule);
   (ii) if a non-resident payer has not been denied a deduction for the payment under similar rules, tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (recommendation 1 defensive rule)

Agreed/Not agreed Agreed/Not agreed

b. Expand the current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (recommendation 2)

Agreed/Not agreed | Agreed/Not agreed

OECD recommendations 1 and 2: detailed design

(d) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (c) are effective:

a. A person who receives a payment which is deductible to the payer in another country should not be entitled to the benefit of any imputation credit attached to the payment.

Agreed/Not agreed | Agreed/Not agreed

b. When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency:

(i) the deduction denied should take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes;

(ii) any net income from the instrument including any foreign currency fluctuations should be non-taxable.

Agreed/Not agreed | Agreed/Not agreed

c. When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the person should not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.

Agreed/Not agreed | Agreed/Not agreed

d. To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee country under another country's controlled foreign company (CFC) regime, the payer should be allowed a deduction for the payment.

Agreed/Not agreed | Agreed/Not agreed

e. If a New Zealand resident share lender lends shares in a transaction subject to the hybrid rules:
   (i) Officials should give further consideration to whether the lender should be taxable on a dividend substitution payment (since such a payment will generally be deductible to the payer);
   (ii) The lender not be allowed an imputation credit on any replacement payment in respect of New Zealand shares, if the share borrower is entitled to a deduction for that payment.

Agreed/Not agreed Agreed/Not agreed

f. If a person holds, pursuant to a share repo arrangement:
   (i) a FIF interest, that person should be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest;
   (ii) New Zealand shares, where the borrower is a non-resident the person is not entitled to the benefit of an imputation credit attached to any replacement payment which is deductible to the borrower.

Agreed/Not agreed Agreed/Not agreed

g. OECD recommendation 1 should only apply to deny a deduction, or include amounts in income, as a result of a timing mismatch between resident and non-resident parties if:
   (i) the mismatch arises on an instrument with a term of 3 years or more or which has been extended to beyond 3 years; and
   (ii) the mismatch is in relation to a payment which the lender is not accounting for, for tax purposes, on a reasonable accrual basis; and
   (iii) it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months of the end of the period in which the expenditure is incurred.

Agreed/Not agreed Agreed/Not agreed

h. Officials give further consideration to the idea that, when a person makes a payment under a hybrid financial arrangement for which a deduction is denied under the hybrid rules, the person may choose at the time of making the payment to treat it as a dividend for purposes of both (but not one only) of the non-resident withholding tax and imputation credit rules.

Agreed/Not agreed Agreed/Not agreed

i. Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.

Agreed/Not agreed Agreed/Not agreed

j. Clarify, if necessary, that interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed Agreed/Not agreed

k. There should be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 3: general principles

(e) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principles, in accordance with OECD recommendation 3, in relation to payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognized under the tax law in the payee country because the payment is disregarded under that law:

a. deny a deduction for the payment if made by a New Zealand payer (recommendation 3 primary rule);
b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, include the payment in ordinary income of the New Zealand resident (recommendation 3 defensive rule);
c. allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against dual inclusion income.

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 3: detailed design

(f) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (e) are effective:

a. in applying the primary rule only, the amount for which a deduction is denied should take into account any foreign currency fluctuations recognized for tax purposes in relation to a financial arrangement denominated in a foreign currency

Agreed/Not agreed Agreed/Not agreed

b. dual inclusion income should be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it should not include income which is protected from New Zealand tax by a foreign tax credit

Agreed/Not agreed Agreed/Not agreed

c. for purposes of the primary rule, full taxation of income under a CFC regime should:

(i) prevent income being treated as not taxable to a payee, and

(ii) qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.

Agreed/Not agreed Agreed/Not agreed

d. when an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that should be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible

Agreed/Not agreed Agreed/Not agreed

e. the ability to claim a deduction in relation to a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred (primary rule) or deemed expenditure arose (defensive rule)

Agreed/Not agreed Agreed/Not agreed

f. amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted

Agreed/Not agreed Agreed/Not agreed

g. denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules;

Agreed/Not agreed Agreed/Not agreed

h. a deduction be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs

Agreed/Not agreed Agreed/Not agreed

i. where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income should be reversed in a later year when there is dual inclusion income earned through the hybrid entity

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 4: general principle

(g) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principle, in accordance with recommendation 4, in relation to payments made to a reverse hybrid entity in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid:

a. deny a deduction for the payment if made by a New Zealand payer (recommendation 4);

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 4: detailed design

(h) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (g) are effective:

a. Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.

Agreed/Not agreed Agreed/Not agreed

b. Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.

Agreed/Not agreed Agreed/Not agreed

c. To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.

Agreed/Not agreed Agreed/Not agreed

d. Non-resident withholding tax should continue to be applied to payments, despite the denial of the deduction.

Agreed/Not agreed Agreed/Not agreed

e. Clarify that interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 5.1

(i) **Agree** that Officials give further consideration to whether New Zealand should modify its controlled foreign company (CFC) rules to include as attributable foreign income all income of the reverse hybrid which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is fiscally transparent (recommendation 5.1).

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 5.2

(j) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand restrict the tax transparency of reverse hybrids established under New Zealand law (recommendation 5.2) by taxing the partnership income of a non-resident partner of a New Zealand limited partnership if:

a. the total foreign-sourced income of the limited partnership exceeds the greater of $10,000 or 20% of the total reverse hybrid income; and
b. the non-resident partner is in a control group with the partnership; and
c. the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not the partner.

(k) **Agree** that:

Inland Revenue recommendation

The Cabinet paper in recommendation (a) should recommend that New Zealand restrict the tax transparency of reverse hybrids established under New Zealand law (recommendation 5.2) by taxing the foreign source beneficiary income of a non-resident beneficiary of a trust with a New Zealand trustee if:

a. the total foreign-sourced income of the trust exceeds the greater of $10,000 or 20% of the total reverse hybrid income; and
b. the non-resident beneficiary is in a control group with the trust; and
c. the non-resident beneficiary is not taxed on their share of the foreign source income of the trust in their residence country because that country views the income as earned by the trustee and not the beneficiary.

Agreed/Not agreed　　　　　　　　　　Agreed/Not agreed

Or

Treasury recommendation

New Zealand should tax the New Zealand and foreign sourced income of a trustee if either the settlor is resident in New Zealand or the trustee is resident in New Zealand, subject to transitional relief for a foreign trustee that migrates to New Zealand to give time to arrange a new trustee for the trust.

Agreed/Not Agreed　　　　　　　　　　Agreed/Not agreed

Or

The tax treatment of trusts should stay as it is.

Agree/Not agreed　　　　　　　　　　Agreed/Not agreed

OECD recommendation 6: general principles

(l) **Note** that in Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand (CAB-17-MIN-0164 refers).

Noted Noted

(m) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principles, in relation to recommendation 6, and consistent with the Budget 2017 decision on foreign hybrid entity double deductions:

a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branches if there is another entity in that foreign country whose income is:
(iii) capable of being offset against the losses of the hybrid entity or branch; and
(iv) not taxable in New Zealand
(recommendation 6 primary);

b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (recommendation 6 defensive);

c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

Agreed/Not agreed Agreed/Not agreed

Detailed design

(n) **Agree** to the following detailed rules to ensure that the general principles contained in recommendations (m) are effective:

a. provide for a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity

Agreed/Not agreed Agreed/Not agreed

b. allow a deduction in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country

Agreed/Not agreed Agreed/Not agreed

c. income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit

Agreed/Not agreed Agreed/Not agreed

d. double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch should be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit should not be regarded as dual inclusion income

Agreed/Not agreed Agreed/Not agreed

e. the ability to claim a deduction in relation in a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred (recommendation 6 primary rule) or deemed expenditure arose (recommendation 6 defensive rule)

Agreed/Not agreed Agreed/Not agreed

f. amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are deducted

Agreed/Not agreed Agreed/Not agreed

g. denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules;

Agreed/Not agreed Agreed/Not agreed

(o) **Agree** that officials consider further whether it is possible to design a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 7: general principles

(p) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principle, in relation to recommendation 7:

Disallow a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 7: detailed design

(q) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (p) are effective:

a. New Zealand amend its existing rules as to consolidation and loss grouping of dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.

Agreed/Not agreed Agreed/Not agreed

b. double deduction amounts and dual inclusion income amounts should be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit should not be regarded as dual inclusion income.

Agreed/Not agreed Agreed/Not agreed

c. the ability to claim a deduction in relation in a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred

Agreed/Not agreed Agreed/Not agreed

d. denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 8: general principles

(r) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principle, in relation to recommendation 8:

a. deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand;

Agreed/Not agreed Agreed/Not agreed

b. do not deny deduction such a deduction if the payment is made to a country that has hybrid mismatch rules

Agreed/Not agreed Agreed/Not agreed

OECD recommendation 8: detailed design

(s) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (r) is effective:

a. When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied should ignore any foreign currency fluctuations on the instrument.

Agreed/Not agreed Agreed/Not agreed

b. Clarify that interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed Agreed/Not agreed

OECD recommendations 9-12: general design and definitional matters

(t) **Agree** that a coordination rule be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.

Agreed/Not agreed Agreed/Not agreed

(u) **Agree** that a specific anti-avoidance rule be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.

Agreed/Not agreed Agreed/Not agreed

(v) **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.

Noted Noted

(w) **Agree** that the effective date of rule relating to unstructured imported mismatches which should be delayed until 1 January 2020.

Agreed/Not agreed Agreed/Not agreed

(x) **Agree** that the effective date of the rules relating to limited partnerships and foreign trusts which are reverse hybrid entities (subject to the decision at Recommendation 5.2 (k) on foreign trusts above) should be income years beginning on or after 1 April 2019

Agreed/Not agreed Agreed/Not agreed

(y) **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:

a. issued directly to, or are traceable to, issues to the public; and
b. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

Agreed/Not agreed Agreed/Not agreed

(z) **Note** that the fiscal impact of agreeing to recommendation (y) is an estimated revenue increase of approximately $71 million over the four years from 2018/19 to 2021/22.

Noted Noted

(aa) **Note** that the fiscal impact set out in recommendation (z) is contingent on [redacted] Withheld under section 9(2)(b)(ii) of the Official Information Act 1982 [redacted]

Noted Noted

Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]

Matthew Gan
Tax Specialist
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

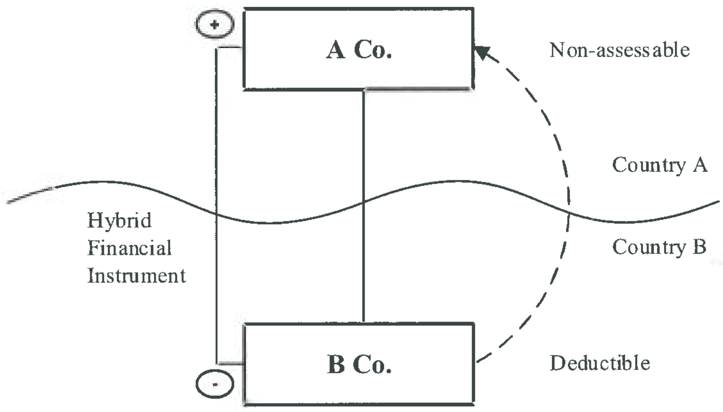
Detailed recommendations

49. We now set out our recommendations for implementing hybrid rules in New Zealand.

Hybrid financial instruments (OECD recommendations 1 and 2)

General

50. We recommend that New Zealand introduce rules, in line with OECD recommendations 1 and 2, to prevent double non-taxation arising from hybrid financial instruments. The following diagram illustrates a typical hybrid financial instrument.



Double non-taxation arises because the payment on the hybrid financial instrument is deductible (as interest) in Country B but not taxable (because it is treated as dividend) in Country A.

51. The OECD recommends that in relation to payments made in connection with financial instruments, countries (in the following order):

- tax dividend payments as ordinary income, if the payments are deductible to the foreign payer (recommendation 2);
- deny a deduction for a payment which is not taxed as ordinary income to the foreign payee and therefore subject to no or a reduced amount of foreign tax (recommendation 1 primary rule); and
- if a payment which is not taxed as ordinary income is deductible to the payer in another country (i.e. that country has not implemented the primary rule), impose tax on that payment as if it were ordinary income (recommendation 1 defensive rule)[1].

52. Recommendation 1 applies only to arrangements between related parties, or which are structured.

[1] If a country has enacted recommendation 2, the defensive response under recommendation 1 would only apply in relation to mismatches where the payee is not treated as receiving a dividend. An example is a sale of property with deferred payment, where the buyer is entitled to a deduction for deemed interest, but the seller is not taxable on that amount as ordinary income.

Recommendations relating to OECD recommendation 2

53. New Zealand already has a rule achieving most of the OECD recommendation 2. This rule denies the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. To ensure that this rule is fully effective, we recommend that it be expanded to:

- tax a dividend if the payment of the dividend triggers a tax credit for the payer in its country of residence, giving the same effect as a deduction, This is proposed in the OECD Final Report[2] and our discussion document; and
- where a deductible dividend has an imputation credit attached, deny the payee the ability to use the imputation credit to reduce their tax liability. The Australian Government announced in its recent Budget that it would also be making this change.

Instruments denominated in a foreign currency

54. We recommend that when the instrument is denominated in a foreign currency (e.g. a loan in a foreign currency), the amount of the recommendation 1 primary rule denial includes the effect of foreign currency gain or loss. Under New Zealand's comprehensive financial arrangements rules, foreign currency gain or loss on a financial arrangement is taxable and (subject to the usual restrictions) deductible, often on an accrual basis. If the arrangement is a hybrid financial instrument in respect of which a deduction for interest is denied under recommendation 1 primary rule, we recommend that this also apply to the foreign currency loss or gain. In the case of a gain, this means the gain is tax exempt. This approach will simplify compliance and is consistent with the conceptual basis for financial arrangement taxation and the hybrid rules. This approach was widely supported in our workshop consultation.

55. We do not recommend taking the same approach to income inclusion under recommendation 2 (except insofar as that will occur through application of the comparative value method under the FIF rules) or the recommendation 1 defensive rule. In those cases, only the actual amount of the deductible payment should be included in the payee's income. Since the payee is not otherwise recognising income in these cases, there is no compliance saving from including foreign currency in the counteraction. Currently, when we apply our domestic rule that corresponds to recommendation 2, we do not include foreign currency, and this does not seem to have caused any difficulty. This approach was also widely supported in workshop consultation.

Whether CFC taxation in a third country is treated as income inclusion

56. We recommend that to the extent that a payment on a hybrid financial instrument can be shown to give rise to taxation of an investor in the payee under another country's controlled foreign company (CFC) regime, the payer should be allowed a deduction for the payment. This was strongly supported in consultation. However, given the complexity involved in demonstrating that this is the case, we recommend that taxpayers who believe a deduction is justified on this basis be required to indicate that (including stating the amount of the

[2] We understand this is based on a tax treatment that applies in Malta.

deduction so justified) when filing their tax return, so the Commissioner is alerted and can audit this claim if she wishes to do so.

Hybrid transfers

57. OECD recommendation 1 is intended to apply to financial instrument lending and financial instrument repo arrangements. We recommend that New Zealand's rules also apply to these transactions. This appears to require a number of technical amendments to the current rules.

58. In relation to share lending (see glossary at Appendix 2) by a New Zealand resident share lender who lends shares in a transaction subject to the hybrid rules (which means it must be with a related party or be a structured arrangement):

- we are considering whether to require that the lender be taxable on a dividend substitution payment, since such a payment will generally be deductible to the payer. This will require over-riding their current ability to use the fair dividend rate method, as if they continued to own the shares;
- we recommend that the lender not be allowed an imputation credit on any replacement payment in respect of New Zealand shares, if the share borrower is entitled to a deduction for that payment.

59. In relation to share repos (see glossary at Appendix 2) we recommend in particular that regardless of whether the transaction is structured or between related parties:

- when the shares are subject to the FIF rules, the money lender (who acquires the shares under the repo, and must re-deliver them at the end of the arrangement) be required to use the comparative value method to determine its income from the shares. This is the same treatment as applies in other situations where shares produce a debt-like return; and
- when the shares are New Zealand shares, the money lender not be entitled to an imputation credit with respect to the dividend. This is already the case as a practical matter, but it ensures that foreign borrowers are not subject to the hybrid rules with respect to any payment they are deemed to make to a New Zealand lender under a share repo.

60. We have consulted on these recommendations both generally and with the Crown entities engaged in share lending. The Crown entities do not see any difficulty with them.

Timing

61. A timing mismatch arises where payments under an instrument are taxable and deductible, but the payer is entitled to a deduction much earlier than the payee has to return income. The OECD recommendation is that timing mismatches should give rise to a hybrid counteraction under recommendation 1 only where the mismatch is not corrected within 12-24 months and there is no reasonable expectation that it will not be corrected within a reasonable period of time. Mismatches arising only from foreign currency movements will not bring an instrument into this rule.

62. We recommend a more clear-cut, less discretionary rule. Under this rule, a timing mismatch would be counteracted under the hybrid rules if it is:

- on an instrument with a term of 3 years or more or which has been extended to beyond 3 years; and
- in relation to a payment for which the lender is not accounting, for tax purposes, on a reasonable accrual basis; and
- not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months of the end of the period in which the expenditure is incurred.

63. If these criteria are met, any timing mismatch will be counteracted, but the counteraction will be reversed as the mismatch reverses. So, for example, a deduction denied under the primary rule will be allowed if and when the income is recognised in the payee country.

64. Our timing approach was widely supported in consultation, and is broadly in line with what we understand Australia is currently proposing.

Interaction with non-resident withholding tax

65. When non-resident withholding tax ("NRWT") (generally at a rate of 10%) is imposed on an interest payment which is non-deductible as a result of the application of OECD recommendation 1, there is an element of double taxation. Taxpayers can avoid this by not issuing hybrid financial instruments. In consultation, this was not regarded as an adequate response to the issue. Accordingly, we recommend that we give further consideration to the idea of allowing taxpayers to choose to treat such a payment as a dividend for withholding tax purposes. The rate of NRWT on a dividend is generally 15%, but this can be reduced or eliminated by attaching imputation credits to the dividend. There are some cases where the rate is as low as 0%. This treatment will have to be elected before the payment is made.

66. We also recommend amending the rules, enacted this year, which prevent deferral of NRWT. These rules apply if a New Zealand borrower from a related party foreign lender calculates its interest expense on an accrual basis, but the relevant interest is not paid for some time, leading to a deferral of the corresponding NRWT. The most significant amendment we propose to this rule is that where interest expense is not deductible under recommendation 1, that interest should not be taken into account when deciding whether or not to apply the anti-deferral rule. This amendment was widely supported in consultation.

Interaction with thin capitalisation regime

67. The thin capitalisation regime denies deductions for a proportion of a group's interest expenses if the group has debt-funded its New Zealand operations above a permissible level. Debt funding will only be taken into account to the extent it gives rise to a deduction. Accordingly, we recommend that where payments under a hybrid financial instrument are subject to permanent deduction denial under recommendation 1 primary rule, they will not be treated as debt for the purpose of this rule. Instruments where there is a timing mismatch would still be treated as debt, but the interest expense would only be subject to the thin

capitalisation rules in the year it is deductible under the hybrid rules. This was supported in consultation, and our initial assessment is that it requires no amendment to the law.

Application to regulatory capital issued by banks and insurance companies

68. Some of the Australian owned banks with New Zealand branches have undertaken significant issues of hybrid financial instruments. These are generally treated as debt in New Zealand but equity in Australia. Although the dividend is taxable in Australia, that tax is generally eliminated because the dividend carries a franking credit which is generated by the payment of Australian tax on other income. These instruments have generally also counted towards the bank's regulatory capital requirements for Australian or New Zealand purposes.

69. We recommend that the New Zealand hybrid rules not exclude regulatory capital (i.e. that required to be issued by banks and insurance companies). The OECD Final Report notes that countries may choose to have such an exclusion. The UK has chosen to do so, though it has other anti-tax arbitrage rules that have applied to bank regulatory capital for some time. Australia has decided not to exclude regulatory capital from its hybrid rules, in its recent Budget. The EU requires member states to include regulatory capital in their hybrid rules by 1 January 2022. Our discussion document also recommended no exclusion.

70. We received several submissions in favour of an exclusion. These submissions and our reasons for not accepting them are contained in Tax Policy Report: Consultation on Addressing Hybrid Mismatches (T2017/406 IR2017/133). Given Australia's decision, New Zealand's position is now largely moot in relation to the trans-Tasman hybrid issues referred to above (with the exception of transitional issues). Because Australia will tax the return on such instruments with no allowance for an imputation credit, New Zealand will continue to allow a deduction.

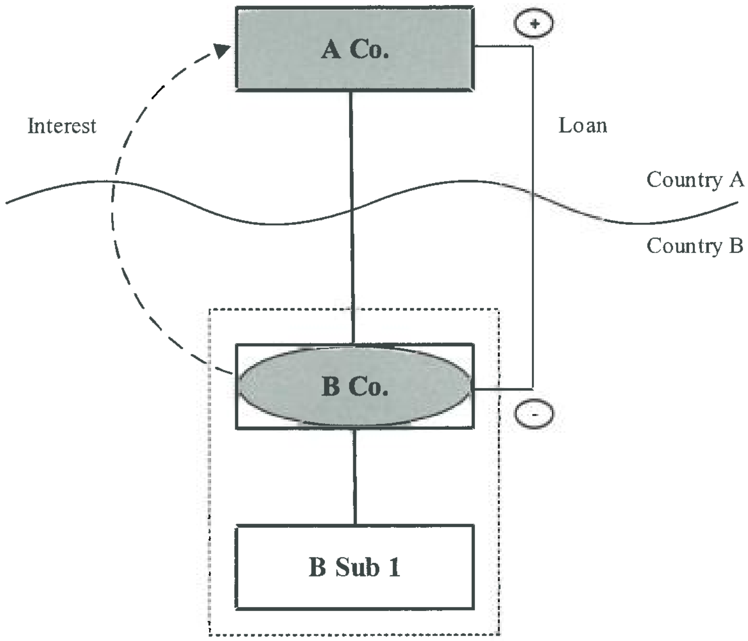
71. We recommend grandparenting from recommendation 1 for deductions claimed in New Zealand by banks and insurance companies in respect of certain capital issued before the release of the discussion document on 6 September 2016. This is discussed more fully under the heading *Effective Date and Implementation.*

Hybrid entities – disregarded payments (OECD recommendation 3)

General

72. We recommend that New Zealand introduce rules in line with OECD recommendation 3 to prevent double non-taxation arising when a hybrid entity makes a payment which is deductible to the payer but disregarded by the payee. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor but opaque for tax purposes in

another country, generally where it is established. A diagram follows, where A Co is the investor and B Co is the hybrid entity.



73. The interest payment by B Co is deductible in the hybrid entity country but disregarded in the investor country. In the New Zealand context, B Co could be a New Zealand company with unlimited shareholder liability, and A Co could be a US company which has chosen to treat B Co as fiscally transparent.

74. Because the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

75. OECD recommendation 3 is that Country B should defer a deduction for such a payment until it is offset by dual inclusion income (discussed immediately below). This is the primary rule. If it does not defer the deduction, Country A should tax the payment, under the defensive rule. Neither rule applies unless the payer and payee are in the same control group (50% or more commonly owned) or the arrangement is structured.

76. Unlike recommendations 1 and 2, recommendation 3 can apply to any kind of deductible payment, e.g. rent, royalties, payments for services, etc.

77. Denial of a deduction under recommendation 3 should be reversed to the extent that the hybrid entity has dual inclusion income. Dual inclusion income is generally speaking income that is taxable in Country A and Country B. If B Co in the above diagram in the same year earns a separate stream of dual inclusion income equal to the amount of the interest payment, it would have:

- no gain or loss in Country B (since the income and interest offset each other); and

- income equal to the amount of the interest payment in Country A (since the income is taxable with no deduction for the disregarded payment).

78. The existence of taxable income in Country A would mean that the tax result is appropriate without the need to apply any hybrid counteraction.

79. The same outcome should apply if the dual inclusion income is earned in a later year. Accordingly the OECD recommends that deductions denied under recommendation 3 be able to be deducted in a later year if there is dual inclusion income. Accordingly, denial under recommendation 3 is in fact only deferral, though the deferral may be permanent if no dual inclusion income ever arises.

Application to deemed payments by branches

80. In line with the OECD branch mismatch report, we recommend that recommendation 3 also apply where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs. So far as policy officials are aware, New Zealand allows a deduction for a deemed payment only in relation to interest on deemed loans by non-resident banks and insurance companies to their New Zealand branches. Where the taxpayer is resident in Australia, our understanding is that the deemed payment is recognised for Australian tax purposes. From a practical perspective, the application of the primary rule of recommendation 3 in a branch context is therefore unlikely.

Carry forward of recommendation 3 defensive counteraction

81. The OECD Final Report does not discuss the possibility of allowing a reversal of amounts of income deemed to arise under the defensive rule in recommendation 3. However, for reasons of principal and consistency, we proposed in our discussion document that where a New Zealand taxpayer has recognised income as a result of receiving a disregarded payment from a foreign hybrid entity, that income should be reversed in a later year when there is dual inclusion income earned through the hybrid entity. We recommend that this reversal be part of the New Zealand hybrids legislation. This is a taxpayer friendly measure, though we do not anticipate the defensive rule often applying in New Zealand.

Foreign currency loans

82. We recommend a similar approach to foreign currency loans subject to recommendation 3 primary rule as the approach set out above in relation to recommendation 1. If the loan is to a New Zealand hybrid, the amount of the deduction subject to denial should take into account foreign currency fluctuations. In this case though, any net income to the NZ hybrid borrower due to foreign currency gain will be taxed as dual inclusion income, rather than exempt.

83. We recommend a different approach to foreign currency loans subject to the recommendation 3 defensive rule to the approach set out above in relation to recommendations 1 and 2. Consistent with the primary rule recommendations, we recommend that foreign currency fluctuations should be taken into account in determining the amount of additional income arising under the defensive rule counteraction. That is because they will also be recognised in determining dual inclusion income, as discussed further below.

Simple implementation solution

84. Foreign currency loans are one aspect of a larger issue in implementing OECD recommendation 3, which arises from the fact that different countries have different rules for calculating income and expense. This poses a challenge for recommendation 3, in particular in relation to the measurement of dual inclusion income.

85. We recommend that dual inclusion income be determined in such a way as to simplify the application of recommendation 3 as far as possible. This means that when applying the primary rule in recommendation 3, dual inclusion income would include all income earned by the hybrid entity from activities the income of which is taxable in the investor country. This income would be calculated in NZ$ and using New Zealand tax principles, without regard to the amount of income actually returned in the investor country from those same activities.

86. Similarly, when applying the defensive rule, New Zealand would treat as dual inclusion income all income from the hybrid as calculated for New Zealand tax purposes, except where that income is protected from New Zealand tax by a foreign tax credit.

87. This simplifying approach was widely supported in consultation.

Whether CFC taxation in a third country is treated as income inclusion

88. As for the OECD recommendation 1, we recommend that to the extent that a payment by a hybrid entity which is disregarded by the payee can be proven to give rise to taxation of an investor in the payee under another country's CFC regime, the payer should be allowed a deduction for the payment. Similarly, amounts which are included in income under another country's CFC regime can qualify as dual inclusion income. However, because of the complexity of CFC taxation, in these cases, we propose that the taxpayer would have to demonstrate that the amounts are fully taxable for CFC purposes in the relevant period.

89. We do not propose that CFC taxation be taken into account when New Zealand is applying the defensive rule in recommendation 3. That is because in that case any taxation imposed in New Zealand under the hybrid rules should be available as a credit against CFC taxation.

Effect of deferred deductions on foreign tax credit limitation

90. A person's ability to claim a credit against New Zealand income tax for foreign income tax imposed on foreign source income is limited to the amount of New Zealand income tax imposed on the net foreign income, i.e. taking into account deductions claimed in New Zealand in relation to that income.

91. This will naturally mean that when a deduction which has been deferred under recommendation 3 primary rule is later allowed, it will lower the foreign tax credit limitation. We recommend that the same outcome should apply when a New Zealand taxpayer has income under the defensive rule in recommendation 3, and that income is reversed in a later year by virtue of dual inclusion income arising in the hybrid entity.

92. The effect of reversing the recommendation 3 counteraction on the foreign tax credit limitation was discussed in consultation, and generally accepted. Submitters did comment that there are already similar existing anomalies in the calculation of foreign tax credits, some of which give results which are unfavourable to taxpayers, and suggested that a more general policy review of the foreign tax credit rules would be appropriate. However, this would have to be undertaken as a separate policy proposal.

Effect of loss of ownership continuity on carry forwards

93. As set out above, deductions deferred under the recommendation 3 primary rule should be carried forward and allowed when and if there is dual inclusion income in a future year. However, we recommend that if the taxpayer is a company, and there is a 51% or greater change in the taxpayer's ownership after the time when the deduction would ordinarily be claimed, the deductions would not be able to be claimed in the future. The same rule would apply to income deemed to arise under the recommendation 3 defensive rule.

94. This is the same rule as applies to deductions for carried forward losses. It ensures that it is not possible for owners of a company to profit from the sale of the company as a tax shelter. That rationale applies in the case of deductions denied under the hybrid rules in just the same way as it applies to deductions which are unusable in the year incurred because they exceed current income. While such deductions are able to be carried forward and used in future years for the benefit of the shareholders who owned the company when the expenses were incurred, they should not be able to be used for the benefit of other shareholders.

95. One of the reasons for making this recommendation is that in some cases, deductions denied under the recommendation 3 primary rule would, if allowed, have formed part of a net loss to carry forward in any event, and thus been subject to elimination on an ownership change in the ordinary way. It would be anomalous in that case for the hybrid rules to have the effect of protecting the carry forward of those expenses from elimination.

96. While officials' position was understood in consultation, it was not entirely accepted by all parties, and may be subject to a degree of criticism. Submitters felt the deferral of a deduction was more like a timing rule (e.g. cash deduction for an accrued expense) which is not subject to carry forward elimination if there is an ownership change between accrual and deduction.

Interaction with NRWT

97. When a payment for which a deduction is deferred under recommendation 3 is subject to New Zealand NRWT, we do not propose that any adjustment be made for that. Recommendation 3 does not permanently deny the deduction – it defers it until there is income in the hybrid. So it would not be appropriate to adopt the same solution being considered for a payment in a recommendation 1 hybrid financial arrangement mismatch and allow the payer to eliminate the NRWT permanently by treating the payment as a dividend. An alternative would be to reflect the imposition of NRWT by allowing a portion of the payment to be deducted. But this would create further complexity, particularly if the payee country has hybrid rules.

98. Accordingly we do not recommend any amendment to the NRWT rules or the hybrid rules to adjust for the imposition of NRWT on a payment for which a deduction is denied under OECD recommendation 3. This may be a point which parts of the private sector will be unhappy with. However, we believe it will generally be possible for businesses to plan around the issue.

99. As for the new rules imposing NRWT on an accrual basis, we propose a similar modification to that proposed as a consequence of enacting OECD hybrid recommendation 1. That is, expenditure for which a deduction is deferred under recommendation 3 would not trigger application of NRWT on an accrual basis.

Interaction with thin capitalisation

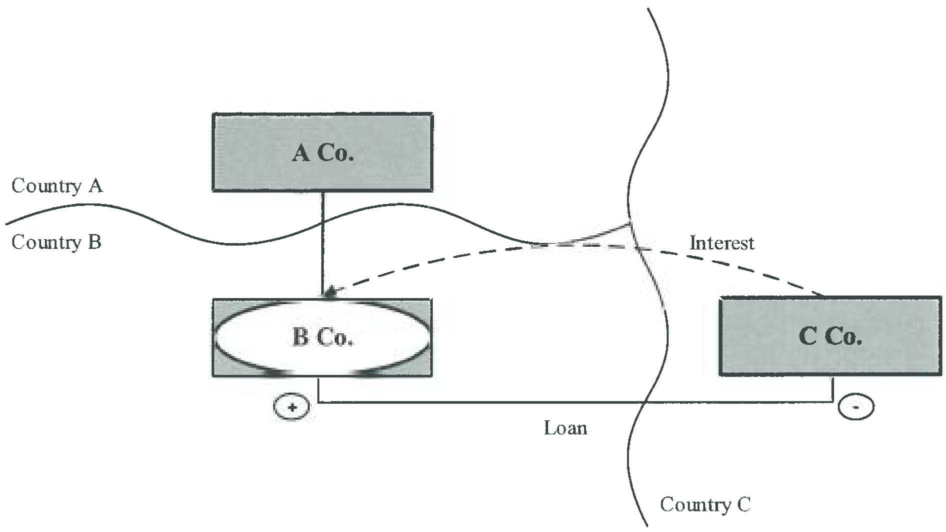
100. We recommend that denial of a deduction under recommendation 3 should have no effect on the thin capitalisation regime. Because interest deductions are only deferred under recommendation 3 rather than denied, there is less reason to amend the application of the thin capitalisation regime than there is in recommendation 1. In addition:

- when a hybrid entity has both interest and non-interest disregarded expenses, only some of which are deferred, an apportionment rule would be necessary to determine the amount of the deferred interest;
- taxpayers will generally manage their thin capitalisation position to avoid any interest denial under the regime.

Deductible payment to a reverse hybrid (OECD recommendations 4)

General

101. We recommend that New Zealand introduce rules, in line with OECD recommendation 4, to prevent double non-taxation arising from a payment to a reverse hybrid where payer, payee and the relevant investor are in a control group. The following diagram illustrates a typical example of the situation proposed to be addressed.



If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co. In this diagram, New Zealand is Country C, and would apply the recommendation 4 counteraction to deny a deduction for the interest payment.

102. OECD recommendation 4 is that countries deny a deduction for a payment to a reverse hybrid if:

- the payment would have been taxed if made directly to the investor (A Co in the case above); and
- the payer, payee and investor are all in a control group or the payment is pursuant to a structured arrangement.

Application to payments to branches

103. In line with the recommendations in the OECD branch mismatch report, we recommend that recommendation 4 also apply to a payment to a control group member which is not taxed to the payee because:

- the payment is a "diverted branch payment". As defined in the OECD branch report, this is a payment which is treated:
    - in the payee country as attributable to a branch in another country and therefore not taxed
    - in the branch country as not attributable to the branch; and
- the payment is to a "disregarded branch". As defined in the OECD branch report, a disregarded branch arises when a payment is treated in the payee country as attributable to a branch in another country, but the branch country does not treat the payee as having a branch which would give the branch country a right to tax.

104. We are not aware of such structures being used in New Zealand. However, UK and OECD officials advised us that structures making use of these types of branch mismatches were widely used in Europe, and that the effectiveness of a country's hybrid measures would be significantly compromised if they were not addressed.

105. Applying the recommendation 4 counteraction to these branch mismatches was accepted in consultation.

Instruments denominated in a foreign currency

106. As for recommendation 1 we recommend that when the payment is on a loan denominated in a foreign currency, the amount of the recommendation 4 denial includes the effect of foreign currency gain or loss.

CFC inclusion

107. As for recommendations 1 and 3 primary rule, we recommend that to the extent that a payment to a reverse hybrid can be proven to give rise to taxation under the owner country's CFC regime, or the CFC regime of a higher tier owner, a deduction should be allowed.

Interaction with non-resident withholding tax

108. As noted in relation to recommendation 1, denial of a deduction under recommendation 4 is permanent, and accordingly the imposition of non-resident withholding tax on the payment will involve a degree of over-taxation. However, because the mismatch does not necessarily arise in relation to hybrid financial instrument (indeed, it may arise on a royalty payment, which is not in relation to a financial instrument at all), there is no basis for recharacterising the payment as a dividend for withholding tax purposes. Accordingly, we do not recommend any adjustment to the imposition of NRWT. This is the approach taken by other jurisdictions. In general the outcome can be avoided by not using reverse hybrid entities.

Interaction with thin capitalisation regime

109. To the extent that a deduction is denied for a payment of interest under recommendation 4, we recommend that the debt corresponding to that deduction, and the payment itself, be treated in the same way as if the deduction were denied under recommendation 1, i.e. it will not be treated as debt for purposes of the rules. .

Reverse hybrids – recommendation 5

110. OECD recommendation 5 is in three parts.

- Recommendation 5.1 suggests countries consider changes to their domestic law so that they tax residents on income which is not taxed in another country due to its being earned by a reverse hybrid;
- Recommendation 5.2 suggests countries consider changes to their domestic law so they tax income which is earned by a reverse hybrid entity established in their country; and
- Recommendation 5.3 suggests countries consider improvements to record keeping and disclosure rules for tax transparent entities established in their country.

111. We propose making changes consistent with recommendation 5.2 and considering further recommendation 5.1. In respect of recommendation 5.3, we believe that New Zealand's record keeping and disclosure rules meet current international standards noting that our rules for foreign trust disclosure have recently been strengthened following the recommendations of the Shewan Report in 2016.

112. However, we note that Australia has indicated that it is unlikely to implement recommendations 5.1 and 5.2 at this point. In respect of recommendation 5.1 this is largely because they see their existing rules as adequate. For recommendation 5.2, we understand that Australia does not see a significant domestic problem that needs to be addressed. By contrast, we consider that the existence of New Zealand limited partnerships and foreign

trusts (discussed below) means it is preferable for New Zealand to follow the OECD recommendations.

Reverse hybrids with a New Zealand investor – recommendation 5.1

113. New Zealand already has a CFC regime which applies to a New Zealand resident holding 10% or more of a foreign company which is controlled by New Zealand residents. Under the CFC regime, such a shareholder is taxed on its share of the foreign company's income of certain kinds, referred to as attributed income. Attributed income includes interest income and certain other passive income, but excludes active income. Accordingly, where a New Zealand resident is an investor in a reverse hybrid, non-taxation by reason of reverse hybridity would only arise in relation to such active income.

114. In consultation, submitters observed that in most cases, active income would already be taxed by the source/establishment country. They therefore questioned the need for any change. However, they accepted that adding to the definition of income subject to attribution under the CFC regime income which is not taxable to the CFC because it is treated by the CFC country of establishment as earned by the New Zealand investor could be the outcome of this project.

115. We note also that there is a de minimis rule in the CFC regime (generally, there is no attribution of income unless potentially attributable income is more than 5% of total income), so attribution will not in most cases be triggered by a relatively small amount of untaxed reverse hybrid income.

116. A rule which taxed CFC income in these circumstances would also apply to a New Zealand resident who uses the attributable FIF income method to calculate FIF income. This method uses the same mechanics as the CFC regime.

117. Although recommendation 5.1 is recommended by the OECD, it is not expected to be adopted by Australia, and it raises some conceptual and practical issues. We would like to consider this matter further and report back.

Reverse hybrids established in New Zealand – recommendation 5.2

118. There are two entities in New Zealand which present a real risk of giving rise to non-taxation as a result of reverse hybridity. They are:

- New Zealand limited partnerships; and
- Trusts with a New Zealand trustee and a foreign settlor or beneficiary.

119. Although a look through company (LTC) may also be a reverse hybrid, the risk of non-taxation is already addressed. A company cannot be an LTC if its foreign income exceeds the greater of $10,000 or 20% of the company's gross income, if more that 50% of the LTC's shares are held by non-residents.

120. In relation to limited partnerships, we recommend that income which is earned by a limited partnership and attributed to a partner who is not taxable on that income and who is in the same control group as the partnership, should be taxable in New Zealand , on the same

basis as if the non-resident partners were resident in New Zealand. This liability should be on both the limited partner and the general partner (who will have a right of indemnity against the limited partner). We recommend a de minimis at the same level as the LTC de minimis referred to above.

Foreign trusts

121. Foreign trusts have been controversial recently because New Zealand's regime for taxing them is unusual internationally and they have been used as a vehicle for investing offshore by some non-resident settlors and the income was not taxed (nor disclosed) anywhere. This was the topic of the Shewan Inquiry which made recommendations (adopted by the Government) to greatly strengthen disclosure requirements. This addressed the use of foreign trusts to disguise illegal activity, but tax advantages through their hybrid nature remain.

122. We describe below two options for addressing the hybrid mismatch. However, given that the Shewan Inquiry found no conceptual basis to disagree with the fundamental tax treatment of foreign trusts, Ministers could want to retain the current treatment. That said, the frame of reference for the Shewan Inquiry was New Zealand tax principles and international disclosure principles, while the reference for the hybrids mismatch proposals is closing arbitrage options between tax treatments of different countries without inquiring whether any country's treatment is correct from its own domestic perspective.

Hybrid mismatch for beneficiary and trustee income (Inland Revenue recommendation)

123. In relation to foreign trusts a reverse hybrid mismatch can arise in relation to beneficiary income in the same way as it can arise for a limited partnership, if income which is treated for New Zealand tax purposes, and on which the beneficiary would be taxed in its country of residence if it derived the income directly, is not taxed because the residence country regards the income as derived by the trustee. Accordingly, if the beneficiary who is not taxable on beneficiary income due to a reverse hybrid mismatch is in the same control group as the trust, and the trust derives more than the greater of $10,000 or 20% of its income from foreign sources, we recommend that the beneficiary income be subject to New Zealand taxation, in accordance with recommendation 5.2.

124. A reverse hybrid mismatch can arguably also arise in relation to trustee income New Zealand does not impose tax on the income of a New Zealand trustee of a foreign trust because of what is often referred to as a settlor approach to trust taxation. We tax foreign source income earned by the foreign trustee of a trust with a New Zealand settlor, on the basis that the income is more appropriately treated as belonging to the settlor (who is a New Zealand resident taxable on worldwide income) than the trustee (who is ordinarily not subject to New Zealand tax on foreign source income). Similarly we do not tax the foreign source income earned by the New Zealand trustee of a trust with a foreign settlor, on the basis that the income is more appropriately treated as earned by the foreign settlor, who is not subject to New Zealand tax on non-New Zealand source income.

125. Since the trustee income of a New Zealand trustee of a foreign trust is taxed as if it were derived by the foreign settlor, there is arguably a hybrid mismatch if the income is not taxed

to the foreign settlor in its residence jurisdiction, and the reason for that non-taxation is that the income has been derived by the New Zealand trustee rather than the settlor directly. Accordingly, if the settlor who is not taxable on trustee income due to a hybrid mismatch is in the same control group as the trust, and the trust derives more than the greater of $10,000 or 20% of its income from foreign sources, we recommend that the trustee be subject to New Zealand taxation in accordance with recommendation 5.2.

Hybrid mismatch comprehensive foreign trust proposal (Treasury recommendation)

126. New Zealand is relatively unusual in having a settlor regime for trust taxation. As far as we know from research undertaken during the Shewan Inquiry, the settlor basis for trust taxation applies only for settlors resident in New Zealand, Japan, and the United States (for some trusts only) (there could be some other jurisdictions that we are not aware of). This means that there may be many cases where recommendation 5.2 applies.

127. A simpler option would be for New Zealand to tax the New Zealand trustee of all trusts with a New Zealand resident trustee, as well as retaining the settlor regime. This would apply a taxing nexus for trustee income that almost all other countries that recognise trusts apply. It would be a simpler test than having to inquire what the settlor and beneficiary tax regimes are for all trusts with a resident trustee, and would largely pick up the same income.

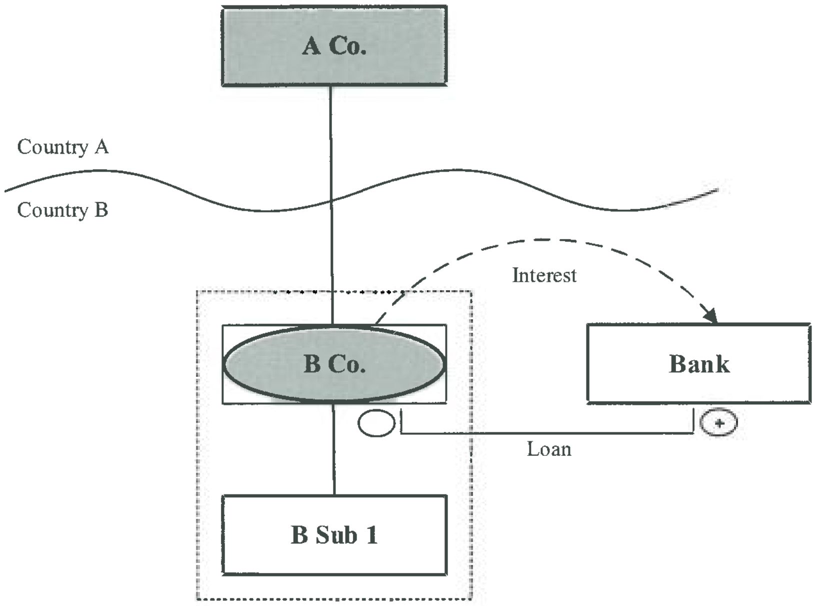
128. Some form of transitional rules may be required in relation to these rules, to deal with events such as trustees who migrate to New Zealand or who become trustees of testamentary trusts. For example, the rules may allow a foreign trustee who migrates and becomes resident in New Zealand up to two years to find a substitute foreign trustee to keep the trust out of the New Zealand tax base. This situation is common internationally for trustees who migrate to another country.

129. In relation to these rules implementing OECD recommendation 5.2, both Inland Revenue and the Treasury recommend that the implementation date be later that for the other measures. Submitters suggested that the private sector may not fully appreciate that trust and partnership structures are within the terms of the hybrid rules. In order to ensure that those affected have adequate time to deal with the proposals, we suggest an implementation date of income years beginning on or after 1 April 2019.

Hybrid entities – double deductions (OECD recommendation 6)

General

130. We recommend that New Zealand introduce rules, in line with OECD recommendation 6, to prevent double non-taxation arising when a hybrid entity makes a payment that is deductible in two countries against non-dual inclusion income. (As discussed elsewhere in this report, this kind of mismatch is currently being used to reduce New Zealand tax, in the Australian limited partnership structures which the Government has already decided to address). A diagram illustrating this possibility follows, where B Co is the hybrid entity.



131. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment is treated as made by a separate company, which is in a tax consolidated group with B Sub 1. Accordingly the interest payment can offset income earned by B Sub 1. This means that each $1 of interest payment can offset $2 of income. The outcome is similar to the outcome of a deductible/non-includible mismatch countered by recommendation 3, but in this case it is caused by a payment being deductible in two countries, rather than deductible and disregarded.

132. OECD recommendation 6 is that:

- The investor country (Country A in the diagram) should deny a deduction for the interest payment (the primary rule); and
- If Country A does not do so, then Country B should deny the deduction (the defensive rule).

133. As noted above, Cabinet has already agreed to implement the primary rule (CAB-17-MIN-0164 refers).

134. Recommendation 6 applies to any kind of expenditure, including allowances such as depreciation.

135. As with recommendation 3, denial of a deduction under recommendation 6 should be reversed to the extent that the hybrid entity has dual inclusion income, either in the same period or a later one.

Application to branches

136. The OECD Hybrids Report was explicit that recommendation 6 applies to expenses incurred by a branch if those expenses are deductible in both the branch and parent countries. For many branches, that is not the case, because the legal entity is established in a country (such as Australia) which exempts active branch income. However, expenses incurred by foreign branches of New Zealand companies will be deductible in two countries. Accordingly, this recommendation is particularly relevant to New Zealand companies.

137. The OECD proposes that recommendation 6 apply if there is any potential for expenditure to be offset against non-dual inclusion income, whether or not it is so offset. This could have made foreign branch losses unavailable to be used against New Zealand source income. A blanket denial of deductions for foreign branch losses would not be a comfortable fit with our current policy settings for taxing branch income, and officials have put considerable effort into consultation designed to ensure that recommendation 6 can be implemented in a way that ensures it does not affect the vast majority of New Zealand companies which have foreign branches that are in loss, but are not using the deduction in the branch country against non-dual inclusion income.

Recommendation for scope of recommendation 6 primary rule

138. Officials accordingly recommend that the primary rule in recommendation 6 apply to expenditure of a foreign branch/hybrid entity with a New Zealand parent/investor only where there is another entity with income that is not taxable in New Zealand but able to be offset in any way by any branch/hybrid entity loss (including where such offset requires an election or other similar step having tax significance only).

139. This restriction means that a New Zealand company with a foreign branch would in most circumstances not be denied a deduction in New Zealand for any branch/hybrid loss under recommendation 6. There would be no denial, for instance, in the case of a New Zealand company with one or more Australian branches if:

- the New Zealand group does not own any other Australian entities; or
- if it does own other Australian entities, those entities' income cannot be offset by any branch loss. We understand that in Australia a loss incurred by an Australian branch of a non-resident company cannot offset income earned by a resident company. On that basis, ownership of an Australian company by the New Zealand group also would be consistent with the non-application of recommendation 6 primary rule.

140. The restriction explained above was generally accepted in consultation, and officials believe that it produces a sensible policy outcome. It does not go so far as denying the branch/hybrid loss only to the extent it is used against non-dual inclusion income. Consultation established that such a rule, though also potentially producing an appropriate outcome, would be much more complex to design and administer.

Recommendation for transitional situations

141. This recommendation means that a rule is required to deal with the situation where a New Zealand resident with a loss-making foreign branch or hybrid at some point becomes subject to recommendation 6 primary rule by virtue of acquiring an interest in an entity in the branch country whose income is not taxable in New Zealand but can be offset by the branch losses. Officials recommend that:

- if the branch loss arising before the acquisition of the interest in the second entity cannot be offset against the new entity's income (as will often be the case, including we understand in Australia), then the only consequence is that subsequent branch losses are subject to the recommendation 6 primary rule; and

- otherwise, all losses of the branch which have been used against New Zealand income should be recaptured, since they are now available to be used against non-dual inclusion income.

142. Officials do not believe this rule will often apply, but it is important for the integrity of the hybrids package.

143. We also recommend a similar rule to operate in favour of a New Zealand resident with a hybrid entity or branch which has been subject to loss denial under recommendation 6. If it becomes impossible for the loss to be used in the branch/hybrid jurisdiction, then it should be allowed in New Zealand. This could occur if, for example, the hybrid is wound up in the foreign country, or if the entity with non-dual inclusion income is sold. In that case the suspended losses would be deductible in New Zealand to the extent of the carried forward loss, as calculated under the rules of the hybrid or branch country, that has become unusable in that country.

Simple implementation solution

144. As with recommendation 3, in order to simplify compliance, we recommend that the amount of double deductible expenditure and dual inclusion income be the amount calculated under New Zealand tax principles, without close regard to whether such amounts match the amounts which are deducible or taxable in the other country. This possibility is referred to in the OECD final report and was strongly supported in consultation.

145. As with recommendation 3 defensive rule, we recommend that when New Zealand is applying the primary rule, income protected from tax by a foreign tax credit would not be dual inclusion income.

CFC taxation in investor country can give rise to dual inclusion income

146. We recommend that income which can be shown to be taxable both in the branch/hybrid country and under CFC rules in the investor country should be able to be treated as dual inclusion income. Again this would not be the case if the CFC taxation is reduced by a credit for tax paid in the branch/hybrid country.

Effect of deferred deduction on foreign tax credit limitation

147. Deductions deferred under recommendation 6 will under existing law reduce the foreign tax credit limitation in the year the deductions are allowed. No change is required.

Effect of loss of ownership continuity on carry forwards

148. As for OECD recommendation 3, we recommend that if a taxpayer subject to recommendation 6 denial is a company and there is a 51% or greater change in its ownership after the time when the deduction would ordinarily be claimed, the deductions would not be able to be claimed in the future.

Interaction with NRWT

149. In relation to the new rules imposing NRWT on an accrual basis, we recommend a similar modification to that recommended for OECD recommendation 3.

Interaction with thin capitalisation

150. We make the same recommendation as for OECD recommendation 3.

Opaque election

151. In consultation, there has been a strong submission that a New Zealand owner of a foreign hybrid entity should be permitted to treat the hybrid as a company, in line with its foreign treatment. Recommendation 6 would then no longer apply to it. This submission was based on a desire for simplicity.

152. Officials understand the reasons for the submission. However we are concerned that it might lead to significant administrative and legislative complexity, for what might be a small handful of taxpayers. Accordingly, we recommend that we consider further whether it is possible to design a tightly targeted and simple opaque election, with a view to reporting back on our recommendations before the proposed bill is finalised.

Dual resident entities (OECD recommendation 7)

General

153. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

154. Dual resident companies give rise to the same double deduction possibilities as hybrid entities. Expenditure incurred by such a company may be able to be used in each residence country to offset non-dual inclusion income, i.e. income taxed only in that country.

155. New Zealand's rules already prevent dual resident companies from grouping their losses or forming part of a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (in many instances) a New Zealand limited liability partnership.

156. Submitters made the point that dual residence can arise inadvertently. For example, a corporate group in New Zealand may incorporate a subsidiary in Australia (which would therefore be an Australian tax resident company) but exercise sufficient director control in New Zealand that the company is arguably also New Zealand tax resident. Officials observe that if this is indeed a problem, it is a problem under the existing rules denying dual resident companies the ability to group losses, be part of a tax consolidated group, or even maintain an imputation credit account.

Similar rules to that applying to changes implementing OECD recommendation 6

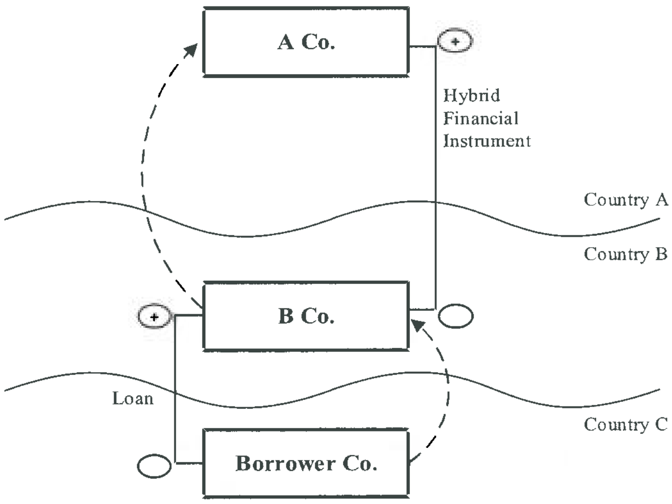
157. The following recommendations made in relation to OECD recommendation 6 also apply in relation to recommendation 7:

- simple implementation solution;
- the effect of deferred deductions on the foreign tax credit limitation;
- the effect of loss of ownership continuity on carry forwards; and
- interact with thin capitalisation.

Imported mismatches (OECD recommendation 8)

General

158. We recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment between members of a control group that funds a payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



159. The interest payment by Borrower Co to B Co does not in isolation give rise to a hybrid mismatch. The loan is treated the same way in both Country B and Country C (which could be New Zealand). However, B Co makes payments to A Co under a hybrid financial instrument. The tax mismatch is not counteracted, because neither country has hybrid rules. If Country C makes no hybrid counteraction in such a case, the hybrid rules are ineffective to deal with arrangements between Country A and Country C. Businesses can avoid the rules simply by going from A to C via B.

160. In order to prevent its hybrid rules being circumvented, Country C can treat the loan from B Co to Borrower Co as an imported mismatch arrangement, and deny a deduction for the interest payments by Borrower Co to the extent that they do not exceed the payments under the hybrid financial instrument between B Co and A Co.

161. The OECD imported hybrid mismatch rule applies to both structured and unstructured imported mismatches.

- A structured imported mismatch arises when a deductible payment is part of a structured arrangement involving a hybrid mismatch – for example if the funding chain the above diagram was entered into deliberately, in order to move money from

A Co to Borrower Co. A structured imported mismatch rule prevents a country's hybrid mismatch rules being deliberately circumvented.

- An unstructured imported mismatch arises when there is no such intention. There is simply a deductible payment by a person resident in a country with hybrid rules, where the payee in turn makes a deductible payment under a hybrid mismatch arrangement (which may itself be an imported mismatch arrangement). The unstructured imported mismatch rule is intended to extend the reach of the hybrid rules, rather than to prevent their deliberate circumvention.

162. The OECD proposes complex apportionment rules which may need to be applied to determine the amount of denial in an unstructured hybrid mismatch.

163. The imported mismatch rule will not need to be applied in respect of payments to a person in a country with the hybrid rules. The payee's country can be relied on to address any hybrid mismatches in that case. Furthermore, as more countries adopt hybrid rules, there should be fewer hybrids and hybrid mismatches in existence, and so less need for the imported hybrid rule to apply.

164. Those we consulted were not generally in favour of countering imported mismatches, on the basis that the hybrid mismatch was not directly with New Zealand. That said, they generally understood the need for a structured imported mismatch rule, but were concerned about the complexity and uncertainty around the unstructured rule. We recommend that this concern be addressed by deferring the application date for the unstructured imported mismatch rule. This recommendation is discussed in more detail under the heading *Effective date*.

Foreign currency instruments

165. When an imported mismatch payment is a return on a foreign currency loan, the issue of how to deal with foreign currency fluctuations arises as it does for the other recommendations. In this case we recommend that the foreign currency is not taken into account. The basis for the counteraction is that the New Zealand payment is funding in some way a hybrid mismatch payment by another entity. The extent of this funding may differ from year to year. Thus it is best measured by reference to the amount of the coupon payment alone, rather than including as well any foreign currency movements, which will generally have no cash flow impact in the relevant year..

Interaction with non-resident withholding tax

166. We do not recommend adjusting any non-resident withholding tax on a payment for which a deduction is denied under the imported mismatch rule. Because the payment will be treated as ordinary income in the payee country, any withholding tax will generally give rise to a tax credit in the payee country.

167. As with the other mismatch denial rules, we recommend that deductions disallowed under the imported mismatch rule not be taken into account when deciding whether or not to apply the anti-NRWT-deferral rule.

Interaction with thin capitalisation regime

168. As with a recommendation 1 (non-timing) and recommendation 4 denial, to the extent that interest on a financial arrangement is subject to denial under the imported mismatch rule we recommend that it not be treated for purposes of the thin capitalisation regime as debt.

Co-ordination rule

169. We recommend that the hybrid legislation includes a rule to deal with the situation where a hybrid mismatch arrangement which is subject to counteraction in one country (say New Zealand) ceases to be so subject, for example because the other country introduces hybrid rules, and is responsible applying taking the primary response. We recommend that this rule be consistent with the approach taken to this issue in the OECD Final Report. We did not receive any submissions against this approach.

Definitions

170. The hybrid rules may require some new definitions to be added to the Income Tax Act, and the amendment of some existing definitions. In particular, a definition will be required of a structured arrangement, and the importance of this was stressed in submissions. We did not receive any submissions against the definitional approach proposed in the discussion document, and recommend that we approach the tax of drafting supporting definitions in line with what was proposed there.

Specific anti-avoidance rule

171. We recommend that the hybrid rules include a specific anti-avoidance rule, allowing the Commissioner to counteract arrangements having a purpose or effect of defeating the intent or application of the hybrid rules.

Effective date, transitional and grandparenting

172. Cabinet has already agreed that OECD recommendation 6 primary rule should apply to New Zealand residents for income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is on the basis that a bill is introduced to Parliament before the end of 2017, and in force before 1 July 2018. We recommend the same start date for all of the hybrid recommendations in this report other than that relating to unstructured imported mismatches and reverse hybrids, discussed below.

173. This may be:

- a similar timetable to that in the UK (where the effective date was 8 months after introduction of the legislation into Parliament); and
- shorter than that proposed in Australia, which has announced that its effective date will be at least six months after its legislation is enacted.

174. In general, we do not see any need for a longer lead time than that we propose. The target and effect of the hybrid rules is has been identified with some specificity, and has not changed in any significant way (other, perhaps, than the addition of branch mismatches

beyond those in recommendation 6). Parties should be able to plan their affairs already with a high degree of confidence as to what the effect of the rules will be.

175. In relation to unstructured imported mismatches:
- there is still considerable uncertainty as to how this rule should apply, given that it requires a co-ordinated counteraction of mismatches that may themselves be difficult to find and to quantify;
- there will be less need to apply the rule as the hybrid rules are enacted in more countries. The unstructured imported mismatch rule does not apply to payments to a country with hybrid rules, and the adoption of the rule by more countries will reduce the number of hybrids in any event;
- the adoption of the rules by more countries may assist in developing an understanding of how the unstructured imported mismatch rule should apply; and
- the rule is more about extending the reach of the hybrid rules than ensuring their integrity.

176. The UK has introduced hybrid rules including an unstructured imported mismatch rule effective 1 January 2017. Australia has not made any announcement. The EU directive includes an unstructured imported mismatch rule which must be effective from 1 January 2020.

177. We recommend that the effective date of the unstructured imported mismatch rule be delayed until 1 January 2020. By that time, all of the EU member states are expected to have hybrid rules, and so the application of the unstructured imported rule will be both less frequent and, we expect, better developed. We do not make the same recommendation for the structured imported mismatch rule, as that would create an integrity issue for the rules.

178. We also recommend a delayed implementation date for the recommendations relating to limited partnerships and foreign trusts which are reverse hybrids. As discussed above, the private sector may not fully appreciate that trust and partnership structures are within the terms of the hybrid rules. In order to ensure that those affected have adequate time to deal with the proposals, we suggest an implementation date of income years beginning on or after 1 April 2019.

Transitional and grandparenting

179. All of the OECD Final Report, the Australian Board of Taxation report, and our discussion document, do not recommend any general transitional relief for existing arrangements. The hybrid rules generally apply to transactions between parties at least 25% commonly owned, or deliberately structured arrangements. They produce tax benefits that generally were not intended, but flow from the unintended interaction of different countries' rules. The effect of the rules will be to remove inappropriate benefits. They will not have a punitive effect (except in relation to the imposition of NRWT), and except to the extent that they do, no exception can reasonably be taken to their application to existing transactions.

180. The absence of transitional relief is the same approach as was taken, without adverse reaction, to certain related party NRWT minimisation structures in the recently enacted Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act

181. We recommend no transitional relief from the hybrid rules, subject to an exception for certain capital issued by banks (and insurance companies – for purposes of discussion we refer only to banks, but similar rules apply to both), as discussed further below.

182. A number of banks operating in New Zealand have issued debt instruments which are both:

- hybrid mismatch arrangements (or imported hybrid mismatch arrangements), in the sense that the return on the instruments is deductible in New Zealand but treated as a dividend in Australia or elsewhere; and
- regulatory capital for capital adequacy purposes, either in New Zealand or Australia.

183. Many of these issues have been made directly to the public in Australia. In some cases the instruments have been issued to a foreign branch of the New Zealand bank's foreign parent Most of them are able to be repaid by the issuer after 5 years.

184. The fact that these instruments raise regulatory capital does not in our view justify any grandfathering. In discussions with the Reserve Bank, they have told us that there is no particular benefit in these instruments from a regulatory perspective, and that they would be comfortable with the banks replacing these instruments with ordinary shares to the extent that the capital they raise is required for regulatory purposes. Accordingly, in our discussion document we did not recommend any special treatment for these instruments.

185. However, these instruments do differ from most hybrids insofar as they are held by third party investors, often retail rather than wholesale (the hybrid rules apply to them because they are structured, rather than related party). This in turn means that if the hybrid rules were to apply to them so as to:

- impose additional tax on the investors, the investors may have a right to be indemnified by the bank (this would be the case if recommendation 2, or recommendation 1 defensive rule applied to the investors); or
- increase the after-tax cost of the funding to the issuer (which might be the result if any of the rules applied), the issuer may have a right to terminate the investment early.

186. The banks have submitted that subjecting regulatory capital to the hybrid regime with no grandparenting would be inappropriate because:

- restructuring such capital would require regulatory approval, possibly from more than one regulator; and
- such restructuring might be disruptive to the financial markets in which bank capital is raised, especially if all the banks were looking to replace their existing issuances at the same time.

187. Different banks made different submissions on the date from which grandparenting should cease to apply, ranging from the date of release of the OECD Final Report (October 2015), through the date of release of the Government discussion document (6 September 2016) to the date of enactment of New Zealand's hybrid legislation. Co-ordination with Australia was also encouraged. In this respect we note that Australia announced in its 2017 Budget that it will:

- apply recommendation 2 to dividends on hybrid regulatory capital, thus denying the payee the benefit of an imputation (or franking) credit; and
- grandparent instruments issued before 8 May 2017.

188. There are some grounds for treating the publicly issued instruments differently from most hybrid instruments. Australia's decision to grandparent also puts a heavy burden of proof on New Zealand to justify a decision to do otherwise. Accordingly we recommend providing some grandparenting. The issues then are:

- which transactions should be grandparented; and
- from what date.

189. As to the first of these, we recommend that only transactions which are directly to the public, or which are traceable to an issue to the public, should be grandparented. However, we have not yet had the opportunity to discuss this in detail with the banks, and may refine or expand this core recommendation as we do so.

190. As to the date, we recommend that grandparenting apply only to transactions entered into before the release of our discussion document on 6 September 2016. That document announced the Government's intention to enact hybrid rules with no regulatory capital exception. It was also a date that was indicated as acceptable in some written submissions, and in consultation.

Withheld under section 9(2)(b)(ii) of the Official Information Act 1982

[redacted]

APPENDIX 1: OVERVIEW OF OECD RECOMMENDATIONS

Linking rule recommendations:

Rec.	*Hybrid mismatch*	*Hybrid arrangement*	*Corresponding branch arrangement*	*Counteraction*	*Scope*
1	D/NI (deduction/ no inclusion)	Hybrid financial instruments (includes timing)		Primary: deny deduction for payment Defensive: include payment in income	Related parties (25%) or structured arrangements
3	D/NI	Disregarded payments	Deemed branch payments	Primary: deny deduction for payment to the extent expenditure exceeds DII Defensive: include payment in income to the extent exceeds DII	Control group (generally 50%) or structured arrangements
4	D/NI	Reverse hybrids – linking rule	Disregarded branch structure and diverted branch payments	Primary: deny deduction Defensive: None (Recommendation 5 acts as a defensive rule)	Control group or structured arrangements
6	DD (double deduction)	Double deductions (including those arising by virtue of a foreign branch)	(Recommendation 6 already applies to double deduction branch outcomes)	Primary: parent/head office country denies deduction to the extent exceeds DII Defensive: subsidiary/branch country denies deduction to the extent exceeds DII	No limit for primary rule. Defensive rule limited to control group or structured arrangements
7	DD	Payments by dual resident company		Deny deduction in both jurisdictions to the extent exceeds DII	No limit
8	Indirect D/NI	Imported mismatches	Imported branch mismatches	Primary: deny deduction for payment to the extent it funds the hybrid or branch mismatch payment Defensive: None	Control group or structured arrangements. Does not apply if payee subject to hybrid rules

Specific rule recommendations:

Rec.	*Hybrid mismatch*	*Hybrid arrangement*	*Corresponding branch arrangement*	*Counteraction*	*Scope*
2	D/NI	Hybrid financial instruments – specific rules		2.1 Payee country should turn off any exemption 2.2 Restrict FTCs to hybrid arrangement	No limit
5	D/NI	Reverse hybrids – specific rules	Disregarded branch structure and diverted branch payments	5.1 Improve CFC and other offshore rules 5.2 Turn off transparency/non-taxation 5.3 Improved disclosure	Specific to individual country's domestic law

APPENDIX 2: GLOSSARY

CFC rules	New Zealand has a controlled foreign companies (CFC) regime that attributes the passive income of CFCs to New Zealand owners. New Zealand's CFC rules are an important part of our international tax rules and are generally considered to be robust.
Deduction/ no inclusion (D/NI)	A hybrid result where a member of a group can claim a deduction for an intra-group payment and that deduction is not balanced by income inclusion for the recipient.
Double deductions (DD)	A hybrid result where a group can claim tax deductions against two different amounts of income for one item of expenditure.
FIF rules • fair dividend rate • cost • deemed rate of return • comparative value method • attributed FIF income method	New Zealand has a foreign investment fund (FIF) regime which seeks to tax New Zealand residents on their portfolio income from foreign share investment in a practical way. There are a number of methods to calculate FIF income, including: • The fair dividend rate (FDR) and cost methods which approximates total annual return as 5% of an investor's holding and taxes on that basis; • The deemed rate of return (DRR) method which approximates total annual return as a rate set by Order in Council each year; and • The comparative value (CV) method which measures change in value across the relevant year plus any other gain such as a dividend and taxes that amount. • The attributed FIF income method, which taxes the resident on a share of the underlying income of the
Foreign branch	A New Zealand company that operates in a foreign country through a permanent establishment in that country. Because New Zealand taxes the worldwide income of its residents, a New Zealand company with a foreign branch operation that is in loss has the potential to create a hybrid outcome as the loss can be used against New Zealand as well as (potentially) offshore income which New Zealand does not tax.
Foreign tax credit	New Zealand's tax law allows its residents to claim a foreign tax credit for tax paid overseas on a segment of foreign-sourced income. If that income is taxable in New Zealand, residents can claim the foreign tax credit against New Zealand tax to prevent double taxation.
Hybrid entities	An entity that is treated for tax purposes as transparent or disregarded (its income and expenditure is attributed to its owners or (in the case of payments to an owner) ignored) in the jurisdiction of its parent/investor and opaque (it is taxed as a separate entity on its income and expenditure) in the jurisdiction it is established in. This type of entity can produce double deductions and deduction/no inclusion outcomes.
Hybrid financial instrument (permanent)	A financial arrangement between two parties (e.g. a convertible note) that is regarded as debt in one country and equity in another. The effect of this misalignment in characterisation is that payments under the arrangement are treated as tax deductible interest to the payer and (generally) tax exempt dividends for the

	recipient.
Reverse hybrid entity	The reverse of a hybrid entity; an entity that is treated for tax purposes as transparent in its establishment jurisdiction and as opaque in the jurisdiction of its parent/investor. This type of entity has the potential to create a double non-taxation result.
Share lending	A transaction where the owner of a share lends that share to another person. Typically the share borrower will transfer collateral to the lender and will pay the share lender a replacement or substitute payment for any dividends rpaid on the shares during the term of the share lending arrangement (which is often very short) if applicable. Share lending has the potential to fall within the hybrid mismatch rules if the arrangement is between related parties or is a structured arrangement, is cross-border, and the two jurisdictions involved take inconsistent views of the substitute payment. Share repos are similar transactions and can produce similar results.
Share repo	Similar to share lending, but this time the shares are provided as collateral for a loan from the share borrower to the share lender. A share repo differs from secured lending because the money lender can sell the shares during the term of the loan, remaining subject of course to an obligation to redeliver them.
Tax consolidation / loss grouping	Tax consolidation refers to the ability of related party entities to consolidate their tax returns. This can have the effect of enabling hybrid outcomes, as hybrid losses (double deductions and unbalanced deductions) can be consolidated with the ordinary income of a related entity. Similarly, loss grouping rules allow a hybrid loss to be transferred into a related party entity that is in profit, thus reducing their taxable income.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

RECEIVED

21 JUL 2017

MINISTERIAL SERVICES UNIT

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Cabinet paper - tax measures to prevent base erosion and profit shifting

Date:	6 July 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1847 IR2017/410

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to the recommendations. **Authorise** the attached Cabinet paper for lodgement with the Cabinet Office.	10am, Thursday 20 July 2017
Minister of Revenue	**Agree** to the recommendations. **Authorise** the attached Cabinet paper for lodgement with the Cabinet Office	10am, Thursday 20 July 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Steve Mack	Principal Advisor, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Carmel Peters	Policy Manager, Inland Revenue	
Paul Kilford	Policy Manager, Inland Revenue	

6 July 2017

Minister of Finance
Minister of Revenue

Tax policy report: Cabinet paper - tax measures to prevent base erosion and profit shifting

1. This report recommends that you authorise the attached Cabinet paper for lodgement with the Cabinet Office by 10am Thursday 20 July 2017 for the Economic Growth and Infrastructure Committee to consider at its meeting on 26 July 2017. This report also recommends you agree to a change to our previously recommended hybrids measures in respect of foreign trusts.

2. The attached Cabinet paper provides an overview of three other Cabinet papers which seek approval for a package of measures to address base erosion and profit shifting (BEPS) in New Zealand. The Cabinet paper also summarises the background to the other papers, highlights the most important aspects of the proposals, and discusses matters common to all three papers (including application dates, publicity, and financial implications). The other papers are:

- BEPS – interest limitation submissions and policy decisions;
- BEPS – transfer pricing and permanent establishment avoidance submissions and policy decisions; and
- BEPS – recommendations on addressing hybrid mismatch arrangements.

3. At the request of your office we have prepared the attached Cabinet paper in advance of the other three. We are currently working on the other papers and will provide those to you next week.

4. We reported to you on the package of BEPS measures to which all four Cabinet Papers relate on 22 June 2017 (T2017/1576, IR2017/325; T2017/1577, IR 2017/330; T2017/1578, IR2017/329; T2017/1604, IR2017/353).

5. If you agree with the drafting of the attached Cabinet paper, we recommend you authorise it for lodgement with the Cabinet Office (together with the other 3 Cabinet papers) by 10am Thursday 20 July 2017 for consideration at the Economic Growth and Infrastructure Committee meeting of 26 July 2017.

Foreign Trusts

6. In regards to foreign trusts, the Cabinet paper is consistent with our recent hybrids policy report (T2017/1604 / IR2017/353), but it also reflects some further policy development as well as filling in a gap in the recommendations contained in the policy report. As set out in that report, in principle we believe that New Zealand foreign trusts can result in double non-taxation due to a hybrid mismatch, where:

- New Zealand does not tax the New Zealand trustee because the beneficiary or settlor is non-resident; and
- the beneficiary's or settlor's residence country does not tax that person because the trustee is non-resident.

7. We now recommend amending that proposal slightly, to clarify that the New Zealand trustee should not be taxable on income so long as someone is required to include that income in their taxable income. So, for example, New Zealand should not tax an amount allocated to a beneficiary if the settlor is required to include that amount in its tax return in its own jurisdiction in that year. Similarly, we should not impose tax on unallocated income retained by the trustee if a beneficiary is required to include the amount in their tax calculation for that year. This clarification is important to avoid our proposed rules imposing two layers of tax on the trust income.

8. Accordingly, we recommend taxing a New Zealand trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that:

- the beneficiary is in the same control group as the trustee (many family trusts would meet this requirement);
- the beneficiary would be taxed on the trust income if it held the trust assets directly; and
- the income is not subject to tax as the income of any person other than the trustee (such as the beneficiary or settlor).

9. We also recommend taxing the New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that:

- the settlor is in the same control group as the trustee (again this would often be the case);
- the settlor would be taxed on the trustee income if it held the trust assets directly; and
- the income is not subject to tax as the income of any person other than the trustee.

10. In error, our policy report did not include any recommendations on trustee income (see recommendation (k)). We therefore take this opportunity to clarify that trustee income is within the scope of the proposed rules, subject to the modifications discussed above.

11. We recommend a de minimis, so that neither of these rules applies if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

12. Importantly, we do not consider any of the changes proposed here are inconsistent with the discussion between officials and Ministers at our meeting on 29 June. We are still only proposing to tax income of foreign trusts to the extent they are "reverse hybrids" and we are not proposing to impose tax on all income of trustees of foreign trusts.

Recommended action

We recommend that you:

(a) **Agree** that New Zealand should tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that:

- the beneficiary is in the same control group as the trustee; and
- the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and
- the income is not subject to tax as the income of any person other than the trustee (such as the beneficiary or settlor)

Agreed/Not agreed | Agreed/Not agreed

(b) **Agree** that New Zealand should tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that:

- the settlor is in the same control group as the trustee;
- the settlor would be taxed on the trustee income if it held the trust assets directly; and
- the income is not subject to tax as the income of any person other than the trustee.

Agreed/Not agreed | Agreed/Not agreed

(c) **Agree** that a de minimis apply, so that neither of the rules in recommendation (a) and (b) applies if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

Agreed/Not agreed | Agreed/Not agreed

(d) **Authorise** the attached Cabinet paper for lodgement with the Cabinet Office by 10am Thursday 20 July 2017 for the Economic Growth and Infrastructure Committee to consider at its meeting on 26 July 2017.

Signed and referred | Signed and referred

Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]

Steve Mack
Principal Advisor
Tax Strategy
The Treasury

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Economic Growth and Infrastructure Committee

TAX MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING

Proposal

1. This paper provides an overview of three attached Cabinet papers seeking approval for measures to address base erosion and profit shifting in New Zealand. This paper also summarises the background to the attached papers, highlights the most important aspects of the proposals, and discusses matters common to all three papers (including application dates, publicity, and financial implications). The attached papers are:

- BEPS – strengthening our interest limitation rules;
- BEPS – transfer pricing and permanent establishment avoidance; and
- BEPS – addressing hybrid mismatch arrangements.

Background

2. Since late 2012, there has been significant global media and political concern about evidence suggesting that some multinationals pay little or no tax anywhere in the world. Initially matters surfaced in the context of Parliamentary and Senate inquiries in the UK, US and elsewhere into the tax avoidance strategies used by multinationals. In 2013 the issue formed part of the G20 agenda who asked the OECD to report back to it on global strategies to address countries' concerns.

3. The OECD reported back to the G20 in July 2013 highlighting the aggressive tax practices used by multinationals to exploit gaps and mismatches in countries' domestic tax rules to avoid tax, now known as "base erosion and profit shifting" (BEPS). They found that BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

4. The end result was the adoption of a G20/OECD 15 point Action Plan recommending a combination of domestic reforms, tax treaty changes, and administrative measures that would allow countries to strengthen their laws in a consistent manner and work together in combatting BEPS. Recognising our own vulnerability to BEPS and the value of working cooperatively, New Zealand actively participated in the OECD/G20 project, which was finalised at the end of 2015.

New Zealand's response to BEPS

5. On the whole, New Zealand is fairly well placed when we assess our tax system against the OECD/G20 recommendations. However, while the majority of multinationals operating in New Zealand are compliant, there are some that adopt BEPS strategies to minimise or eliminate their New Zealand tax obligations. It is important to address these BEPS activities without reducing the general attractiveness of New Zealand as an investment destination.

6. In June last year the Government released its own programme to address BEPS issues in New Zealand (CAB-16-MIN-0218 refers). This programme presented a measured approach that prioritises the problems observed in relation to New Zealand's laws. At the same time, it is a coherent package of measures. Stripping the tax benefits from one type of arrangement is ineffective if multinationals can get the same benefit from switching to a different type of arrangement.

7. In summary the Government's package of New Zealand domestic law measures:

- prevent multinationals from using artificially high interest rates on loans from related parties (interest limitation);

- prevent multinationals from using artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand;

- prevent multinationals from using transfer pricing payments to shift profits to their offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore; and

- remove the tax advantages of exploiting hybrid mismatches between different countries' tax rules.

8. New Zealand's response to BEPS is generally aligned with Australia's response. It is also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment. Appendix One provides a table that compares New Zealand's and Australia's response to the OECD's BEPS Action Plan.

9. The detail of the BEPS proposals was subsequently set out in three Government discussion documents, which were released for public consultation in September 2016 and March 2017:

- *BEPS – Strengthening our interest limitation rules;*
- *BEPS – Transfer pricing and permanent establishment avoidance;* and
- *Addressing hybrid mismatch arrangements.*

10. Our officials have since received a significant amount of feedback on the discussion documents. Most of the submissions were from tax advisors to the affected businesses and raised concerns about uncertainty and compliance costs. We consider that these additional costs will mostly be borne by those who the measures are designed to address (taxpayers engaging in BEPS activities) and that the overall benefits to New Zealand of addressing BEPS outweigh these costs. We have used this feedback to refine the measures, so they are more certain for taxpayers and better targeted. These refinements should not reduce the overall effectiveness of the proposed measures. We consider the measures will address the BEPS issues we are concerned about.

11. The following are what we consider to be the most important matters coming out of consultation. This is not an exhaustive list. The individual Cabinet papers accompanying this paper also discuss other significant issues raised by submitters.

12. Finally we note the progress in relation to the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (also known as the multilateral instrument or MLI) signed by the Minister of Revenue on behalf of New Zealand in June. The MLI is intended to prevent our double tax agreements from being used to facilitate BEPS.

Main issues on BEPS – Strengthening our interest limitation rules

13. One of the easiest ways to shift profits out of New Zealand is for a foreign parent of a New Zealand subsidiary to fund the subsidiary with a loan rather than equity. This is because the interest paid to the parent is deductible to the subsidiary thereby reducing its taxable income. The specific problem we have identified is that transfer pricing rules are not effective in limiting the rate of interest that can be charged on that loan.

Proposal on pricing related-party debt

14. The discussion document proposed a hard rule to limit the interest rate on related-party debt to an amount close to the parent's cost of external borrowing - specifically an interest rate cap, based on the credit rating of the offshore parent plus a small margin. Submitters argued that this proposal could affect the interest rates of companies with only small amounts of debt (so not seen as a risk to the tax base) and could be difficult to apply if the parent has no credit rating. They were also concerned that it could produce results that were inconsistent with our tax treaties, leading to double taxation.

15. In light of these concerns we recommend using what we have termed a "restricted transfer pricing approach" for debt. We expect that this approach will generally result in the interest rate on related-party debt being in line with that facing the foreign parent. This is because the debt would be priced under a transfer pricing methodology but (i) be carried out with a rebuttable presumption that the borrower could be expected to be supported by its foreign parent; and (ii) disregard any commercially unattractive terms used to justify an excessive interest rate. We also intend that taxpayers be able to challenge the rate using the dispute resolution process in tax treaties. The Australian Taxation Office has recently released administrative guidelines which outline a similar approach for limiting related party interest rates (albeit Australia is implementing this approach as an operational policy, rather than a law change).

Proposal on allowable debt levels

16. The second interest limitation issue relates to allowable debt levels under our thin capitalisation rules. These rules limit the quantity of debt a foreign-owned subsidiary can have (generally to 60 percent of the subsidiary's assets). We propose to adjust what counts as "assets" by reducing them by "non-debt liabilities" (liabilities other than interest-bearing debt).

17. While there was some support for the broad proposal, submitters were very concerned about one aspect: that the proposed change would include what are known as "deferred tax liabilities." Accounting standards require deferred tax to be recognised in certain situations – broadly, where profits for tax and accounting purposes differ. This is a complicated issue, with some types of deferred tax liabilities having a stronger case for exclusion than others.

We recommend that officials consider this matter further as part of future consultation on the detailed design of the interest limitation proposals, with Cabinet delegating us the power to make a decision.

Main issues on BEPS – Transfer pricing and permanent establishment avoidance

18. The *BEPS – transfer pricing and permanent establishment avoidance* Cabinet paper contains measures to strengthen our transfer pricing rules, counter permanent establishment avoidance and help Inland Revenue deal with uncooperative multinationals.

Proposal on Transfer Pricing Time Bar

19. The discussion document proposed extending Inland Revenue's time bar for adjusting a taxpayer's transfer pricing position from four to seven years. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have shorter time bars for other tax disputes) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Proposal on permanent establishment avoidance

20. This proposal is aimed at preventing taxpayers from structuring their affairs to avoid a taxable presence in New Zealand where one exists in substance. The OECD has updated their model tax treaty to address this issue and New Zealand is adopting this into our tax treaties by signing the OECD's multilateral instrument. In addition to this, like Australia and the UK, we are also introducing a permanent establishment avoidance rule into our domestic law. The domestic law change is necessary to cover cases where the relevant tax treaty does not yet include the OECD's new recommendation. Submitters were of the view that the proposed rule was too broad and would catch ordinary commercial arrangements that were not its intended target. We agree that any rule should be more narrowly targeted at avoidance arrangements and therefore recommend that officials consult further with submitters to achieve this result.

Main Issues on BEPS – Addressing hybrid mismatch arrangements

21. The *BEPS – addressing hybrid mismatch arrangements* Cabinet paper proposes measures to remove the tax advantages of hybrid mismatch arrangements. Hybrid mismatch arrangements arise when countries classify transactions and entities differently from each other under their domestic tax laws. For example, fixed rate shares may be treated as debt in one country and shares in another, thus allowing the payment of an amount that is deductible in the payer's country but non-assessable in the payee's. Australia, the UK and EU member countries are taking similar actions to address BEPS from hybrid mismatches.

Scope of the rules

22. The hybrids proposals in the discussion document covered the full suite of OECD recommendations in this area, even though there is limited evidence of some of the structures being used in New Zealand. Submitters therefore suggested that our rules should concentrate on the known mischief. On balance, we recommend a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New

Zealand context. Tackling only the known structures might leave a loophole to use those that are not covered, encouraging taxpayers to move into different tax-efficient hybrids rather than converting to more conventional funding structures. A partial response also ignores the fact that some of the other structures might actually be in use, but have not been picked up by Inland Revenue audit.

Foreign Trusts

23. Foreign trusts are, simply put, trusts that have a New Zealand trustee, but are set up by a non-resident (the settlor) and generally derive only foreign-sourced income. Under current settings, foreign trusts are not taxed in New Zealand, except on any New Zealand sourced income. This was confirmed as appropriate by the 2016 Government Inquiry into Foreign Trust Disclosure Rules (the Shewan Inquiry). However, the Shewan Inquiry's conclusion was based on the existing tax settings and the hybrids project has the potential to change these settings in certain circumstances.

24. From a tax policy perspective, foreign trusts are treated as transparent in New Zealand. New Zealand takes the view that, to the extent the income is not paid to beneficiaries more or less as earned, it should be taxed to the settlor in their home jurisdiction. By contrast, the jurisdiction of the settlor may see the trust as a separate entity and not tax the income on the mistaken assumption that the trustee is being taxed in New Zealand. When the income of the trust is not taxed anywhere in the world because of the different tax treatment the relevant countries place on the trust structure, we recommend the New Zealand trustee be subject to tax. This measure would not result in double taxation of current year trust income.

25. We anticipate this meaning that most foreign trusts will be taxed in New Zealand on their foreign sourced income. However, it is important to note that this does not mean that they all will be. The relevant enquiry is "would the income be included in the tax calculation of the settlor in their own country if they had earned that income directly?" If the answer is "no" (and there might be numerous reasons why this would be the case, such as if the settlor is tax exempt, or in a country that does not tax residents on their worldwide income) then no New Zealand tax would be imposed. If the answer is "yes" then New Zealand tax should be imposed unless the income is included in the tax calculation of any person in the same control group (for example, the settlor or a beneficiary) in their own country in the corresponding income year.

26. Finally, we note that taxing foreign trusts in this way was signalled when the hybrids consultation paper was released in September 2016. However, because this rule has the potential to apply to both foreign trusts and limited partnerships, and because the foreign trust industry has very recently incurred significant compliance costs associated with the recommendations of the Shewan Inquiry, we are recommending a delayed effective date to give these structures time to assess their options.

Application dates and transitional measures

27. The measures should generally apply from income years beginning on or after 1 July 2018. Cabinet has already noted that the reforms are expected to apply from this date (CAB-17-MIN-0164 refers). This is based on the expectation that the legislation will be progressed to enactment before this date.

28. The new administrative powers for Inland Revenue to deal with uncooperative multinationals should apply from the date the legislation is enacted. We also propose different

application dates for two of the specific hybrid mismatch proposals. We recommend the unstructured imported mismatch rule (explained more fully in the attached BEPS – addressing hybrid mismatch arrangements Cabinet paper) apply from 1 January 2020 and the reverse hybrid measures (generally expected to apply to limited partnerships and foreign trusts) apply for income years beginning on or after 1 April 2019.

29. We do not recommend any additional transitional relief from the measures, except:

- relief from the hybrids measures for certain hybrid financial instruments issued to the public before 6 September 2016 (the date on which the hybrids discussion document was released); and

- relief from the transfer pricing and interest limitation measures for arrangements subject to an advance pricing agreement entered into before 1 July 2018. (An advance pricing agreement is a binding ruling from Inland Revenue that confirms that the taxpayer's planned transfer pricing positions are compliant with the transfer pricing rules for up to five years.)

Consultation

30. Officials consulted widely on the measures in the attached papers. Discussion documents were released for public feedback on the relevant topics (referred to in paragraph 8 above). For the hybrids proposals, given the earlier release of that discussion document, officials have undertaken a further round of consultation on the details of the proposals with interested stakeholders. Inland Revenue and Treasury officials have also consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment. In addition, officials have discussed some of the measures with their counterparts in the Australian Taxation Office, the Australian Treasury and the OECD secretariat.

General feedback on measures

31. Submitters generally acknowledged the importance of addressing BEPS risks facing New Zealand and agreed in principle that change is needed to strengthen the current rules. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more workable and better targeted. We have incorporated many of these suggestions into the measures on which we now seek Cabinet approval.

Feedback on economic impact

32. Some submitters argued that the proposals will have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. They also argued that the proposed measures were complex and onerous, and may induce foreign companies to remove their existing personnel from New Zealand.

33. It is true that there will be additional tax and compliance costs for some investors but these are necessary to address the issues. We have used consultation to refine the proposals, minimise unintended impacts and better target the BEPS concerns. This should reduce the additional compliance costs, although it will not eliminate them. The higher tax payments resulting from these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. At the same time, these

multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded partners throughout the OECD and the expected tax revenue increase is expected to be relatively small. Given this, we believe any impacts on foreign direct investment into New Zealand will not be material and implementing these measures remains in New Zealand's best economic interests.

Feedback on application date

34. The discussion documents did not indicate a likely application date. However, some submitters expected the Government to seek an early application date and argued that it would be better to allow taxpayers time to consider the proposals and rearrange their affairs if necessary.

35. We expect to receive more submissions on, and opposition to, the application date once affected parties become aware it is proposed to be 1 July 2018.

Further consultation

36. Following Cabinet decisions on these papers, we recommend Inland Revenue and Treasury officials engage in further targeted consultation on outstanding policy issues and technical design details relating to the measures. Due the timing constraints necessary for a 1 July 2018 application date, we are not proposing that submitters be consulted on an exposure draft of the entire bill before the bill is introduced to Parliament. However, we recommend targeted consultation of specific sections where additional consultation will provide the most value ahead of the bill's introduction.

Financial implications

37. Some of the revenue for these proposals has already been included in Budget 2017 forecasts. These are:

	$m – increase/(decrease)						
Vote Revenue	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Foreign hybrid entity double deductions	-	-	25.000	50.000	50.000	50.000	50.000
BEPS taxation bill	-	-	25.000	50.000	50.000	50.000	50.000
Total Revenue effect	-	-	50.000	100.000	100.000	100.000	100.000

38. If our recommendations in these Cabinet papers are agreed and adopted by the Government, then the forecasts would be adjusted upward by these additional amounts:

	$m – increase/(decrease)					
Vote Revenue Minister of Revenue	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Grand-parenting of certain hybrids issued to the public	-	19.000	19.000	19.000	14.000	-
Other BEPS measures	-	45.000	90.000	90.000	90.000	90.000
Total Revenue effect	-	64.000	109.000	109.000	104.000	90.000

39. The additional revenue from the hybrids measures results from our proposed grand-parenting approach for hybrid financial instruments issued to the public before 6 September 2016. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

40. We are recommending that officials continue to consult on details of how deferred tax liabilities and assets should be dealt with under the interest limitation measures - specifically, the measure to eliminate assets funded by non-debt liabilities from a taxpayer's total assets for thin capitalisation purposes. The above fiscal impact assumes deferred tax liabilities are included in the non-debt liabilities adjustments (as per the proposal in the discussion document). If these assets and liabilities were excluded from the adjustments the revenue forecast would be $10 million per year lower. In the attached paper on interest limitation we are asking Cabinet to delegate to us the authority to make a decision on this along with an authority to update the relevant revenue forecasts, if necessary.

41. The revenue in paragraph 37 was treated as a saving in Budget 2017. We propose the additional revenue in paragraph 38 be treated as a saving in Budget 2018.

Administrative impacts

42. The changes proposed in the BEPS discussion documents and recommended in these Cabinet papers are not expected to increase administrative costs or require any significant systems changes for Inland Revenue. This is because the reforms largely change the way some taxpayers self-assess the income and deductions that they report to Inland Revenue. Further, the administrative amendments we are recommending should make it easier for Inland Revenue to deal with uncooperative multinationals.

43. We note, however, that a common theme in submissions on all three discussion documents was that administration of the proposals would place a higher demand on Inland Revenue's audit and investigation functions. Our view is that any required increase in Inland Revenue's resourcing as a result of the BEPS package will be accommodated within existing baselines.

Human rights

44. There are no human rights implications arising from the measures.

Legislative implications

45. Legislative changes to the Income Tax Act 2007 and the Tax Administration Act 1994 will be required to implement the proposed measures. To achieve this, we intend to include the measures in a BEPS taxation bill introduced after the General Election. The BEPS bill will need to be introduced and have its first reading by 14 December 2017 in order to be enacted in time for the planned 1 July 2018 application date.

Impact Analysis Requirements

46. There are no regulatory implications arising directly from this Cabinet paper.

47. The regulatory impact analysis for each set of measures is set out in the Cabinet paper for those measures.

Publicity

48. We will arrange for an appropriate announcement of the policy decisions on these BEPS measures.

49. We also recommend that the Government proactively release the BEPS Cabinet papers, policy reports and submissions on the BEPS discussion documents and the issues paper on the multilateral instrument (including the pre-Budget 2017 policy report and Cabinet paper (T2017/949, IR2017/237)). This could be done when we announce the package. Given their inevitable release under the Official Information Act in any event, releasing these documents proactively will promote transparency around the policy process to the public, rather than just individual requestors. It would also be consistent with the approach taken for previous BEPS Cabinet papers.

Recommendations

50. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** we have developed and consulted on a package of measures to counter certain base erosion and profit shifting (BEPS) activities we are concerned about in New Zealand. In summary, the measures in the package:

   - prevent multinationals from using artificially high interest rates on loans from related parties (interest limitation);

   - prevent multinationals from using artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand;

   - prevent multinationals from using transfer pricing payments to shift profits to their offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore; and

   - remove the tax advantages of exploiting hybrid mismatches between different country's tax rules.

2. **Note** the attached three Cabinet papers seek Cabinet approval to introduce these BEPS measures.

3. **Agree** that work progresses along the indicative timeline, where we plan to introduce a BEPS taxation bill by the end of this year, and enact the bill by 1 July 2018.

4. **Agree** that the measures should apply from income years starting on or after 1 July 2018, apart from:

   - The new administrative powers for Inland Revenue to deal with uncooperative multinationals should apply from the date the legislation is enacted;

   - the hybrids unstructured imported mismatch measure, which should apply from 1 January 2020; and

   - the reverse hybrid measures (generally expected to apply in relation to limited partnerships and foreign trusts), which should apply for income years beginning on or after 1 April 2019.

5. **Agree** that there should be transitional relief from the measures:

   - in relation to the hybrid measures, relief for hybrid financial instruments issued to the public before 6 September 2016; and

   - in relation to the transfer pricing and interest limitation measures, relief for arrangements subject to an advance pricing agreement entered into before 1 July 2018.

6. **Note** the original BEPS revenue that was forecast in April:

	$m – increase/(decrease)						
Vote Revenue	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Foreign hybrid entity double deductions	-	-	25.000	50.000	50.000	50.000	50.000
BEPS taxation bill	-	-	25.000	50.000	50.000	50.000	50.000
Total Revenue effect	-	-	50.000	100.000	100.000	100.000	100.000

7. **Note** the following changes as a result of the decisions in recommendations 1 to 5 above, with a corresponding impact on the operating balance:

	$m – increase/(decrease)					
Vote Revenue Minister of Revenue	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Tax Revenue: BEPS taxation bill	-	64.000	109.000	109.000	104.000	90.000
Total Revenue effect	-	64.000	109.000	109.000	104.000	90.000

8. **Note** the attached paper on interest seeks delegated authority for the Minister of Finance and the Minister of Revenue to make a decision on the treatment of deferred tax liabilities which includes authority to reduce the revenue forecast by $10 million per year.

9. **Note** that forecast BEPS revenue in recommendation 6 above was treated as savings in Budget 2017.

10. **Agree** that the additional revenue in recommendation 7 be treated as savings in Budget 2018 (total to be confirmed after the decision on the treatment of deferred tax liabilities which could reduce the revenue forecast by $10 million per year).

11. **Agree** that Inland Revenue and the Treasury undertake further targeted consultation on outstanding policy issues, technical design details and selected parts of an exposure draft of the planned BEPS bill in relation to the measures.

12. **Agree** to proactively release the Cabinet papers, policy reports and submissions for the BEPS discussion documents and the issues paper for the multilateral instrument.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Appendix One: Comparison of Australia's and New Zealand's response to the OECD's BEPS Action Plan

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
1 – Address the tax challenges of the digital economy	Report identified issues raised by the digital economy and possible actions to address them. Did not generally recommend fundamental changes to international tax framework.	Generally robust and consistent with current international tax norms.	New Zealand imposed GST on online services. *GST imposed on supplies occurring on or after 1 October 2016.*	**Same response as New Zealand.** Australia to impose GST on online services. *GST imposed on supplies occurring on or after 1 July 2017.*
2 – Neutralise the effects of hybrid mismatch arrangements	Recommended domestic hybrid mismatch rules. Changes to the OECD Model Tax Convention and multilateral instrument (MLI) to address hybrid entities.	Domestic law and Double Tax Agreements (DTAs) already contain some targeted anti-hybrid mismatch rules.	New Zealand proposing comprehensive domestic hybrid mismatch rules based on OECD recommendations. *Public consultation in 2016/17. Legislation for domestic rules to be introduced late 2017/early 2018.* NZ has adopted MLI hybrid provisions to strengthen DTAs. *Consulted on the MLI in March 2017. NZ signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand.** Australia proposing comprehensive domestic hybrid mismatch rules based on OECD recommendations. However, we understand Australia is not adopting hybrids recommendation 5 (reverse hybrids) while we are proposing that New Zealand adopt this. *Public consultation in 2015/16. Domestic law changes to take effect from 1 January 2018 or six months after legislation is enacted. Draft legislation expected to be consulted on shortly.* Australia has also adopted MLI hybrid provisions to strengthen DTAs. *Consulted on MLI in December 2016. Australia signed the MLI on 7 June 2017. Ratification of the MLI will follow.*

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
3 – Strengthen Controlled Foreign Company (CFC) rules	Recommendations regarding the design of domestic rules	NZ and Australian CFC rules are already consistent with OECD recommendations.	No proposal to change CFC rules.	**Same response as New Zealand.** No proposal to change CFC rules.
4 – Limit base erosion via interest deductions and other financial payments	Recommended interest limitation using an EBITDA approach.	New Zealand and Australia both have an asset-based thin capitalisation test to control quantity of debt, which the OECD also recommends. Transfer pricing has limited ability to control high-priced debt.	New Zealand is improving its thin capitalisation rules by limiting interest rates on related party debt having particular regard to the interest rate of the foreign parent, and an adjustment for so-called “non-debt liabilities”. *Consulted on interest limitation rules in March 2017. Legislation planned for 2017/18.*	**Similar response to New Zealand.** Australia has already tightened its transfer pricing rules. Since the New Zealand discussion document was published the ATO has released administrative guidelines (in draft) on what arrangements are considered low risk and close alignment with the interest rate of the foreign parent is an important factor. Both these changes will help it challenge high interest rates on related-party debt. **New Zealand is proposing the same rules as Australia in relation to the adjustment for non-debt liabilities.** Australia already requires an adjustment for non-debt liabilities.
5 – Counter harmful tax practices more effectively, taking into account transparency and substance	Finalise review of member country regimes. Expand participation to non-OECD members and revision of existing criteria.	NZ’s and Australia’s laws are already robust – no harmful tax practices identified.	NZ complies with requirements to exchange binding rulings and advanced pricing agreements as recommended by OECD.	**Same response as New Zealand.** Australia complies with requirements to exchange binding rulings and advanced pricing agreements as recommended by OECD.

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
6 – Prevent treaty abuse	Changes to the OECD Model Tax Convention and changes to DTAs through MLI to insert a general anti-avoidance provision called a "principal purpose test" (PPT).	NZ's and Australia's anti-avoidance law is generally strong, but MLI presents opportunity to further strengthen.	NZ to adopt PPT through signing the MLI. *Consulted on MLI in March 2017. NZ signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand**. Australia to adopt PPT through signing the MLI. *Consulted on MLI in December 2016. Australia signed the MLI on 7 June 2017. Ratification of the MLI will follow.*
7 – Prevent the artificial avoidance of Permanent Establishment (PE) status	Changes to the OECD Model Tax Convention and changes to DTAs through MLI to prevent PE avoidance.	NZ's and Australia's PE definition is generally based on the existing OECD and UN Models.	NZ to implement OECD best practice standards for majority of DTAs by signing the MLI. *Consulted on MLI in March and signed MLI on 7 June 2017. Ratification of the MLI will follow.* NZ also proposing a new anti-avoidance rule for large multinationals that structure to avoid having PE in NZ. *Consultation on PE anti-avoidance rule in March 2017. Legislation planned for 2017/18.*	**Similar response to New Zealand on some of the PE measures, but Australia has chosen not to implement changes to the DTA dependant agent PE provision through the MLI, but rather adopt them through bilateral negotiations.** *Consulted on MLI in December 2016. Australia signed the MLI on 7 June 2017. Ratification of the MLI will follow.* Australia's Multinational Anti-Avoidance Law (MAAL) targets PE avoidance. *Applies from 1 January 2016.*

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
Actions 8-10 – relate to transfer pricing to ensure transfer pricing reflects economic substance	Changes to the OECD Transfer Pricing Guidelines.	NZ and Australia currently apply the OECD Transfer Pricing Guidelines. Recent Australian law changes are consistent with the new OECD Transfer Pricing Guidelines. New Zealand law requires updating to reflect new OECD Transfer Pricing Guidelines.	New Zealand will follow the changes to the OECD Transfer Pricing Guidelines. This involves making changes to domestic legislation. *Consulted on transfer pricing in March 2017. Legislation planned for 2017/18.*	**Similar response to New Zealand** on transfer pricing, but generally goes further than New Zealand (and OECD recommendations), by applying a separate Diverted Profits Tax (DPT). Legislation for the separate DPT was introduced on 9 February 2017 and it will take effect in July 2017.
11 – Establish methodologies to collect and analyse data on BEPS and the actions to address it	Recommendations regarding data to be collected and methodologies to analyse them.	NZ and Australia collect and analyse certain data on BEPS as a matter of course.	Since 2015 Inland Revenue has conducted an annual International Questionnaire that collects key data to assess BEPS risks. The most recent survey covered almost 600 foreign owned corporates. Additional data collection from significant enterprises is being considered as part of the BT programme of work.	**Similar response to New Zealand.** ATO requires taxpayers to complete an international dealings schedule and has implemented an International Structuring and Profit Shifting (ISAPS) initiative. This initiative requested data from certain Australian companies at a level similar to the country-by-country (CbC) data requested under the OECD BEPS Action Plan.

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
12 – Require taxpayers to disclose their aggressive tax planning arrangements to revenue authorities	Recommendations regarding the design of domestic disclosure rules.	For both NZ and Australia, no requirement under current law to disclose aggressive tax planning arrangements, however the combination of our strong anti-avoidance laws and the binding rulings and penalties regimes incentivise disclosure.	No law reform planned but existing law incentivises disclosure. Taxpayers will often apply for binding rulings on potentially aggressive transactions to obtain certainty as to the tax treatment – especially in light of our strong anti-avoidance law. Penalties on aggressive transactions are reduced for early disclosure of the arrangement.	**Different to New Zealand.** While Australia has a rulings regime and reductions in penalties for voluntary disclosure, the Australian Treasury is also consulting on whether to adopt the OECD proposals for mandatory disclosure of tax information. Submissions closed on 15 July 2016. Australia also recently implemented transparency measures allowing the ATO to publish the taxable income and income tax liabilities of large companies.
13 – Re-examine transfer pricing documentation	Changes to OECD Transfer Pricing Guidelines and recommendations regarding the design of domestic rules, including country-by-country (CbC) reporting.	NZ and Australia currently apply the OECD Transfer Pricing Guidelines, but do not have a formal programme for automatic exchange of transfer pricing documentation.	Inland Revenue is implementing CbC reporting. NZ has signed the multilateral agreement on exchanging CbC reports with other tax authorities. NZ also recently entered into a bilateral arrangement with the US Internal Revenue Service to share CbC reports. *Where domestic legislation is required to support the changes to the Transfer Pricing Guidelines, this will be introduced in 2017/18.*	**Similar response as New Zealand**. Australia is implementing CbC reporting. It has enacted necessary domestic law and has signed the multilateral agreement on exchanging CbC reports with other tax authorities. In addition, Australia requires large multinationals to file their local and master file documentation with the ATO. *Applies from 1 January 2016.*

Action Report	OECD recommendation	Current law	NZ response to OECD recommendations	Australian response to OECD recommendations
14 – Make dispute resolution mechanisms more effective	Recommendations on operational minimum standards and best practices for dispute resolution	NZ and Australia have strong dispute resolution systems, but do not currently allow taxpayers to approach the competent authority (CA)[1] of *either* DTA partner for resolution of dispute (taxpayer must approach home country CA) and do not generally offer arbitration of CA disputes.	NZ will implement OECD recommendations on dispute resolution by signing the MLI – in particular, NZ will allow taxpayers to approach the CA of either DTA partner in a treaty dispute and provide for arbitration of CA disputes. NZ also recently issued guidance on the mutual agreement procedure (MAP). *Consulted on the MLI in March 2017 and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand**. Australia will implement OECD recommendations on dispute resolution by signing the MLI – in particular, it will allow taxpayers to approach the CA of either DTA partner in a treaty dispute and provide for arbitration of CA disputes. *Consulted on the MLI in December and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*
15 – Develop the MLI to strengthen DTAs	The MLI implements substantive recommendations made in OECD's Action 2, 6, 7 and 14 reports. Report identified public international law and tax issues; and recommended an Ad-Hoc Group be set up to develop the MLI.	NZ has a network of 40 DTAs. Some of the MLI provisions are already included in a few DTAs.	NZ officials participated in the Ad Hoc Group to develop the MLI and New Zealand signed the MLI on 7 June 2017. NZ expects to ratify the MLI in 2018 and our DTAs are likely to begin to be modified in 2019. *Consulted on the MLI in March 2017 and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*	**Same response as New Zealand**. Australian officials participated in the Ad Hoc Group to develop the MLI and Australia signed the MLI on 7 June 2017. *Australia consulted on the MLI in December and signed the MLI on 7 June 2017. Ratification of the MLI will follow.*

[1] CA is a person authorised by a DTA to administer tax treaty provisions and resolve disputes.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: BEPS Cabinet papers

Date:	13 July 2017	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2017/1901 IR2017/429

Action sought

	Action sought	Deadline
Minister of Finance	**Authorise** the attached Cabinet papers for lodgement with Cabinet Office.	10am, Thursday 20 July 2017
Minister of Revenue	**Authorise** the attached Cabinet papers for lodgement with Cabinet Office.	10am, Thursday 20 July 2017

Contact for telephone discussion (if required)

Name	Position	Telephone
Steve Mack	Principal Advisor, The Treasury	Withheld under section 9(2)(a) of the Official Information Act 1982 [redacted]
Carmel Peters	Policy Manager, Inland Revenue	
Paul Kilford	Policy Manager, Inland Revenue	

13 July 2017

Minister of Finance
Minister of Revenue

Tax policy report: BEPS Cabinet papers

1. This report recommends that you authorise the 3 attached Cabinet papers for lodgement with the Cabinet Office by 10am Thursday 20 July 2017 for the Cabinet Economic Growth and Infrastructure Committee (EGI) to consider at its meeting on 26 July 2017.

2. The three attached papers are:

- *BEPS – strengthening our interest limitation rules*. This paper contains measures to limit the ability of multinationals to use interest payments to shift their New Zealand profits offshore.
- *BEPS – transfer pricing and permanent establishment avoidance*. This paper contains measures to strengthen our transfer pricing rules, counter permanent establishment avoidance and help Inland Revenue deal with uncooperative multinationals.
- *BEPS – addressing hybrid mismatch arrangements*. This paper proposes measures to remove the tax advantages of hybrid mismatch arrangements.

3. These 3 papers form a comprehensive package of measures to address base erosion and profit shifting (BEPS). We reported to you on these measures on 22 June 2017 (T2017/1576, IR2017/325; T2017/1577, IR 2017/330; T2017/1578, IR2017/329; T2017/1604, IR2017/353).

4. We also reported to you on another related Cabinet paper on Thursday 6 July 2017 (T2017/1847, IR2017/410) called *Tax measures to prevent base erosion and profit shifting*. This covering Cabinet paper summarises the background to the 3 attached papers, highlights the most important aspects of the proposed measures, and discusses matters common to all three papers (including application dates, publicity, and financial implications). We recommend that all four Cabinet papers be lodged together with the Cabinet Office.

Next steps

5. The following table sets out the next steps for the measures set out in the Cabinet papers.

Date	Milestone/action
10am, Thursday 20 July	Lodge four BEPS Cabinet papers with Cabinet Office (if you agree with their contents)
Wednesday 26 July 2017	EGI

Monday 31 July 2017	Cabinet
August – October 2017	Further consultation on the measures
14 December 2017	BEPS bill containing the measures introduced
30 June 2018	BEPS bill to be passed by this date
1 July 2018	Application date for most measures

Recommended action

We recommend that you:

(a) **Note** that we reported to you on 6 July 2017 on a covering Cabinet paper called *Tax measures to prevent base erosion and profit shifting* which summarises the background to the 3 attached papers, highlights the most important aspects of the proposed measures, and discusses matters common to all three papers (including application dates, publicity, and financial implications).

Noted Noted

(b) **Authorise** the attached 3 Cabinet papers for lodgement with the Cabinet Office (and their attached regulatory impact assessments), along with the covering Cabinet paper referred to above, by 10am Thursday 20 July 2017 for the Cabinet Economic Growth and Infrastructure Committee to consider at its meeting on 26 July 2017.

Authorised Authorised

Withheld under section 9(2)(a) of the Official Information Act 1982
[redacted]

Steve Mack
Principal Advisor
Tax Strategy
The Treasury

Carmel Peters

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – strengthening our interest limitation rules

Proposal

1. This paper seeks Cabinet approval to strengthen New Zealand's rules that prevent excess interest deductions being taken in New Zealand. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, have large interest deductions leaving little taxable profit in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

3. We recommend that Cabinet agree in principle to two major reforms to our interest limitation rules:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the rules that set the debt levels allowed in New Zealand for taxpayers with international connections (the thin capitalisation rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

4. We also recommend several minor improvements to the rules to ensure they are robust and fit for purpose.

5. These changes follow the Government discussion document *BEPS – strengthening our interest limitation rules (March 2017).* In general, submitters on the discussion document acknowledged the need to respond to BEPS concerns but most did not agree with the specific proposals put forward.

6. Some of the proposals have been modified in response to these submissions. In particular, the approach for setting the allowable interest rate on related-party loans is different to that proposed in the discussion document. We anticipate that this new approach will address many, but not all, of submitters' concerns.

7. There are some technical elements to these reforms that could benefit from further discussion with stakeholders. We therefore request that authority be delegated to the Minister of Finance and the Minister of Revenue to finalise the reforms.

8. The forecast revenue from implementing these changes is $45m in 2018/19 and $90m per annum from 2019/20. Note, however, that one technical detail to be canvassed in the further discussion with stakeholders could reduce the forecast revenue by up to $10m per annum.

Background

9. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, are able to take large interest deductions. This results in little taxable profit being left in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

10. Accordingly, in March this year the Government released the discussion document *BEPS – Strengthening our interest limitation rules*. There were two key proposals: one to strengthen how related-party debt is priced, and one tightening the rules governing allowable debt levels.

11. The discussion document also recommended several minor improvements to New Zealand's interest limitation rules to ensure they are robust and fit for purpose.

Comment

12. The majority of multinationals operating in New Zealand have relatively conservative debt positions, and the Government is committed to making sure New Zealand remains an attractive place for them to do business.

13. However, there are some multinationals that deliberately attempt to minimise their tax payments in New Zealand by engaging in BEPS strategies, such as by having related-party debt with excessive interest rates. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

14. Accordingly, we recommend changes to New Zealand's interest limitation rules, most significantly:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the thin capitalisation rules, which set the debt levels allowed in New Zealand for taxpayers either with foreign parents (the inbound rules) or foreign subsidiaries (the outbound rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

Restricted transfer pricing

15. When borrowing from a third party (such as a bank), commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context, such as when a New Zealand subsidiary borrows from its foreign parent. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

16. Broadly speaking, transfer pricing a loan agreement involves determining (hypothetically) the interest rate a third party lender would be willing to lend at, given the terms and conditions of the related-party loan. It is a fact specific and resource intensive exercise and can be manipulated (for example, by adding terms and conditions to the related-party loan that are not frequently seen between unrelated parties). We note that commentators such as Richard Vann, a professor of tax at the University of Sydney, have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

17. For these reasons, the international consensus is moving away from using ordinary transfer pricing as the primary mechanism to limit the interest rates on related-party debt. The OECD, for example, has recommended that countries adopt a simple formulaic approach for limiting interest deductions, which would largely eliminate the advantage of using related-party debt with excessive interest rates (this approach was raised in consultation but was not supported by submitters as it would make a taxpayer's allowable interest deductions volatile. Instead, as outlined below, we are recommending that the current rules for setting allowable debt levels be buttressed by rules that ensure related-party interest rates are appropriate).

18. Accordingly, we recommend that the allowable interest rate for inbound related-party loans be determined under a *restricted transfer pricing* methodology. Inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have substantial third party debt featuring those terms and conditions.

19. The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

20. This *restricted transfer pricing rule* would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate that is the same as the interest rate facing the borrower's foreign parent would automatically be considered acceptable. This safe harbour would be attractive to many companies as it is both simple and provides certainty.

21. We note that the Australian Taxation Office has recently released administrative guidelines which outline a similar approach for limiting related-party interest rates (albeit Australia is implementing this approach as an operational policy, rather than a law change).

Private sector consultation

22. This *restricted transfer pricing rule* is different to the proposal suggested in the March discussion document. The original proposal was a hard rule to cap the interest rate a foreign parent could charge its New Zealand subsidiary based on the foreign parent's credit rating (an "interest rate cap").

23. We consider that the *restricted transfer pricing rule* is a more workable way of achieving essentially the same objective – ensuring the interest rate on related-party debt is in line with what would actually be paid on third party debt. While the methods (restricted

transfer pricing and the interest rate cap) are different in approach, the outcome of both will generally be the same – with differences only at the margin. Accordingly, both approaches have the same revenue impact.

24. Submitters on the March discussion document did not support the original proposal. Many submitters argued that a new approach for pricing related-party debt is unnecessary, noting that the Government proposed to strengthen the transfer pricing rules generally (in the other March discussion document *BEPS – transfer pricing and permanent establishment avoidance*).

25. Some submissions highlighted the consequences of adopting a blunt rule in the nature of the cap. These include concerns that:

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating); and
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

26. It should be noted that the *restricted transfer pricing rule* we are recommending will address many, but not all, of submitters' concerns because it is still a significant departure from using ordinary transfer pricing. Accordingly, we expect it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur with any frequency because of the shift in the international consensus on what is acceptable in relation to the pricing of related-party debt.

Allowable debt levels in the thin capitalisation rules

27. New Zealand has rules to prevent the excessive use of debt by foreign-owned entities operating in New Zealand (inbound investment) and New Zealand-owned entities with international operations (outbound investment). Interest deductions are denied to the extent that the entity's debt level with reference to its assets is determined to be excessive.

28. The March discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

29. The core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. Under the current rules, where non-debt liabilities are ignored, companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment of non-debt liabilities also mean the rules apply unevenly across companies: companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

30. In addition, one of the objectives of the thin capitalisation rules (ensuring that a taxpayer is limited to a commercial level of debt) is undermined by the current treatment of non-debt liabilities. A third party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

31. Australia requires this same adjustment for non-debt liabilities.

Private sector consultation

32. This proposal was accepted by some submitters but opposed by others who argued, for example, that the proposal amounts to a substantial reduction in the amount of deductible debt allowable under the thin capitalisation rules. Overall, this proposal was much less contentious than the interest rate cap.

33. None of the submissions against the core proposal convinced us that the analysis above, suggesting that the non-debt liability adjustment is appropriate, is incorrect. Accordingly, we recommend that the proposed adjustment to the allowable debt level under the thin capitalisation rule proceed. That is, a taxpayer's allowable debt level under the rules should be set with reference to their assets net of their non-debt liabilities.

34. A near-universal comment from submitters was that certain non-debt liabilities – most significantly *deferred tax liabilities* – should be carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept. Accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. Submitters argued that this is often not the case – deferred tax liabilities are frequently technical accounting entries and do not reflect future tax obligations. Submitters also pointed to the rules in Australia, which do include a carve-out for deferred tax liabilities and assets.

35. We recommend further consultation on whether deferred tax should be carved-out from this non-debt liability adjustment. Many, but not all, deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future. Given the concerns raised by submitters, further consultation on this technical detail would be beneficial.

Other changes

36. We recommend five other changes to the thin capitalisation rules:

- a special rule for infrastructure projects (such as public private partnerships) that are controlled by a single non-resident;
- a de minimis for the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;

- removing the ability to use asset valuations for the thin capitalisation rules that differ from those reported in a firm's financial accounts; and

- removing the ability to measure assets and debts on the final day of a firm's income year.

37. These measures were all discussed in the March discussion document. Some were supported by submitters, while others were opposed. Where they were opposed, we are recommending changes to the proposals which will, in general, address submitters' concerns.

Rule for infrastructure projects

38. We recommend a special rule that allows all of a taxpayer's third party debt to be deductible even if the debt levels exceed the normal thin capitalisation limits, provided the debt is non-recourse with interest funded solely from project income.

39. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously.

40. This rule was well received by submitters; however, some technical issues have been raised which we will consult further on.

De minimis for the inbound rules

41. The thin capitalisation rules that apply to New Zealand-owned taxpayers with foreign operations (the outbound rules) has a de minimis (the rules do not apply if a taxpayer has interest deductions of less than $1 million). The thin capitalisation rules that apply to foreign-owned taxpayers (the inbound rules) do not have a similar de minimis.

42. We recommend the current de minimis in the outbound rules be extended to taxpayers subject to the inbound rules, provided the taxpayer has only third party debt. This proposal is to reduce compliance costs for small foreign-owned entities that have a low risk of BEPS.

43. This proposal was generally supported by submitters.

Allowable debt levels for companies owned by a group of non-residents

44. At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level is the greater of:

- 60 percent; and

- 110 percent of its third party debt.

45. However, this means that a taxpayer with high levels of third party debt can be funded with almost no equity. For example, a project funded 90 percent with third party debt could have 9 percent shareholder debt and only 1 percent equity.

46. To address this, we recommend changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. This proposal was generally accepted by submitters.

47. The March discussion document proposed that this change be grandparented, as the rules it relates to (for non-residents acting together) have only just taken effect. We recommend that the precise design of this grandparenting be subject to further consultation with stakeholders, with decisions on its final design being delegated to the Ministers of Finance and Revenue.

Asset valuations

48. In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative to its financial statement value, provided that would be allowable under generally accepted accounting principles.

49. While it is permissible to use an asset's net current value, the thin capitalisation rules set out what is required if taxpayers utilise this option. Accordingly, we recommend that this new net current valuation option be available only if certain criteria are met – such as if the valuation is from an independent expert valuer.

Agency consultation

50. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, and publicity

51. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

52. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

53. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

54. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – strengthening our interest limitation rules* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing their overall effectiveness.

3. **Agree** that the interest rate on inbound related-party loans should be set using a *restricted transfer pricing* rule, whereby the interest rate is set under transfer pricing but ignoring all surrounding circumstances, terms, and conditions that could result in an excessive interest rate unless similar terms apply to significant amounts of third party debt, and with the rebuttable presumption that the borrower would be supported by its foreign parent.

4. **Agree** that a taxpayer's allowable debt level in the thin capitalisation rules should be set with reference to its assets less its non-debt liabilities.

5. **Agree** that the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of $1 million or less, be made available also to foreign-controlled taxpayers provided they have no owner-linked debt.

6. **Agree** that an exemption should be provided from the thin capitalisation rules for certain infrastructure projects funded entirely with third party limited recourse loans.

7. **Agree** that, when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.

8. **Agree** that clear legislative requirements be developed for when taxpayers choose to value their assets for thin capitalisation purposes on a basis other than that used in their financial accounts.

9. **Agree** that an anti-avoidance rule should be inserted into the thin capitalisation rules, to apply when a taxpayer substantially repays a loan just before the end of the year.

10. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

11. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

12. **Authorise** the Minister of Finance and the Minister of Revenue jointly to take final decisions on the extent to which deferred tax liabilities are included in non-debt liabilities, up to a limit of reducing the level of expected revenue increases

anticipated by the BEPS measures as set out in recommendation 7 in the accompanying Cabinet paper *Tax Measures To Prevent Base Erosion And Profit Shifting* by up to $10 million per annum

13. **Agree** that the results of the decisions in recommendations 3-12 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – strengthening our interest limitation rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*The analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The problem the proposals discussed in this impact statement seek to address is the use of debt financing by taxpayers to reduce their New Zealand income tax liability significantly.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The adoption of a restricted transfer pricing rule for determining the allowable interest rate (for tax purposes) on related-party loans from a non-resident to a New Zealand borrower will help ensure interest rates on such loans cannot be excessive. In addition, changing the way deductible debt levels are calculated under the thin capitalisation rules will ensure that taxpayers with little equity are unable to have large amounts of deductible debt. These changes will provide a solution that is sustainable, efficient and equitable, while minimising impacts on compliance and administration costs.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that the new interest limitation rules are forecast to produce approximately $80–90 million per year on an ongoing basis. There are also efficiency and fairness benefits to these proposals which cannot be assigned to particular beneficiaries.

Where do the costs fall?
The costs primarily fall on foreign-owned taxpayers operating in New Zealand (though there may be some minor impacts on New Zealand-owned taxpayers with international operations). Tax payments for affected parties are forecast to increase by approximately $80–90 million per year on an ongoing basis.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
As with all tax rules, there is some risk of taxpayer non-compliance. However, this is mitigated as the rules predominately apply to large companies – and the tax affairs of large companies are closely monitored by Inland Revenue.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is moderate evidence in relation to the problem of excessive interest rates on related-party debt, and good evidence in relation to allowable debt levels. Inland Revenue has some data on interest rates paid on related-party debts, as well as examples of structures that appear to have the effect of increasing the interest rate on such debt. However, this data is not comprehensive. Inland Revenue has data on the debt, asset and equity levels of significant foreign-owned enterprises, which allows an accurate estimation of the impact of the non-debt liability adjustment for those firms.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *BEPS – strengthening our interest limitation rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the Quality Assurance criteria.

Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – strengthening our interest limitation rules

Section 1: General information

Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy changes to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis

Evidence of the problem

While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire. This dataset includes debt levels, related-party debt levels, and related-party interest payments of large foreign-owned firms.

However, there are still limitations to that data – for example, data on interest rates on related-party debt (and the interest rates facing a New Zealand subsidiary's parent company) is not captured in the Questionnaire. Where possible, this information was obtained from other sources (such as credit ratings of parent companies and disclosed related-party interest rates in financial statements) or estimated (for example, estimating interest rates based on related-party interest payments and related-party debt amounts). However, this other data is less comprehensive and accurate.

Consultation

The preferred option in relation to limiting interest rates on related-party interest rates has not been subject to consultation. This was because it was developed in response to submissions on the original proposals. However, it is similar in many respects to the original proposal, which was subject to consultation. In addition, to ensure the rule operates effectively and to mitigate the risk of unintended outcomes, it will be subject to consultation with submitters on the technical detail.

Responsible Manager (signature and date):

Carmel Peters
Policy Manager, Policy and Strategy
Inland Revenue

13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to tax planning strategies used by some multinational enterprises (MNEs) to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over MNEs not engaged in BEPS and domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter BEPS.

BEPS using interest deductions

The use of debt financing is one of the simplest ways of shifting taxable profits from one jurisdiction to another. For example, because interest payments are deductible, a related-party cross-border loan from a parent to a subsidiary can be used to reduce taxes payable in the jurisdiction that the subsidiary is located.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations. This includes developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4).

If no further action is taken, MNEs that currently have high levels of debt in New Zealand, or highly-priced related-party debt, will be able to continue paying little tax in New Zealand. There is also a risk that additional MNEs would adopt similar structures.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

New Zealand's tax system has been the subject of numerous broad-based reviews – most recently the Victoria University of Wellington Tax Working Group in 2010. It is well regarded and generally functions well.

No other government agencies have a direct interest in the tax system. However, a good tax system is important for a well-functioning economy – many government agencies therefore

have an indirect interest in the tax system.

Foreign investment in New Zealand is generally taxed under our company tax at 28 percent. New Zealand's tax system has rules that limit the deductible debt levels and interest rates for taxpayers with foreign connections. These rules affect only foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Thin capitalisation rules

New Zealand has "thin capitalisation" rules to limit tax deductions for interests that non-residents are allowed. These rules generally require an investment owned by a non-resident to have a debt-to-asset ratio of no more than 60 percent (interest deductions are denied to the extent the allowable debt-to-asset ratio is exceeded).

Thin capitalisation rules also apply to New Zealand-owned firms (frequently referred to as the "outbound thin capitalisation rules"). These rules generally require a debt-to-asset ratio of no more than 75 percent. They are designed to prevent a disproportionate portion of a New Zealand company's debt being placed in New Zealand.

Like the tax system as a whole, we consider that the thin capitalisation rules are serving us well. The rules are well understood and taxpayers subject to the rules generally have conservative debt levels and, for those with related-party debt, the debt is at conservative interest rates – as evidenced by the significant amount of tax paid by foreign-owned firms operating in New Zealand (foreign controlled firms paid 39 percent of company tax in the 2015 tax year).

Transfer pricing rules

It is important to limit not just the quantum of debt in New Zealand, but also the interest rate on that debt. For third-party debt, commercial pressures will drive the borrower to obtain as low an interest rate as possible. However, these pressures do not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates. Broadly speaking (and as they apply to related-party debt), these rules seek to ensure that the interest rate on a given loan contract is in line with what would have been agreed between unrelated parties.

NRWT

While payments of interest to related parties are deductible, they are subject to non-resident withholding tax (NRWT). NRWT applies at either 15 percent or 10 percent, depending on whether New Zealand has a Double Taxation Treaty with the interest recipient's home jurisdiction. This means that, while the use of debt can reduce tax payable in New Zealand, it does not completely eliminate it.

2.3 What is the policy problem or opportunity?

A simple way that non-residents can reduce their New Zealand tax liability significantly is by capitalising a New Zealand investment with debt instead of equity, because they can then take interest deductions in New Zealand. This is shown in the example below.

Example
Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.

Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.

Having a generally well regarded tax system does not mean that tax changes are unnecessary. An on-going policy challenge is to ensure that our tax rules are up to date and ensure that MNEs are paying a fair amount of tax in New Zealand. Base protection measures – such as rules for limiting the amount of debt allowable in New Zealand, and the interest rate on that debt – are therefore important.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

This impact statement considers two related policy opportunities:

- ensuring the rules for setting the allowable interest rates on related-party debt are sufficiently robust; and
- ensuring the basis for setting the allowable debt level in the thin capitalisation rules is appropriate.

Scale of the problem

The OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan) included developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4). We consider the fact that the OECD has included profit shifting using interest in its BEPS Action Plan as evidence that this is a significant policy issue internationally.

As mentioned above, most MNEs operating here have relatively low levels of debt and do not have interest rates considered to be excessive. However, there are a small number of taxpayers with either debt levels that are too high, or interest rates that are excessive. While small in number, the fiscal impact of these arrangements is significant – we estimate the tax revenue lost is $80–90 million per year.

2.4 Are there any constraints on the scope for decision making?

There are no constraints on scope.

2.5 What do stakeholders think?

Stakeholders

The stakeholders are primarily taxpayers (in particular, MNEs) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules.

Consultation already undertaken

In March 2017, the Government released the discussion document *BEPS – strengthening our interest limitation rules*. The discussion document consulted on two key proposals which are considered in this impact statement – new interest limitation rules and a non-debt liabilities adjustment to the thin capitalisation rules.

The Government received 27 submissions on the discussion document. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

In general, submitters acknowledged the need to respond to BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, many submitters did not support the specific proposals put forward.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Interest limitation

The discussion document proposed moving away from a transfer pricing approach for pricing inbound related-party loans. Instead, the allowable interest rate for such a loan would – in most instances – be set with reference to the New Zealand borrower's parent's borrowing costs (referred to as an "interest rate cap").

General reaction

Most submitters argued that the interest rate cap proposal was not necessary and should not proceed. They noted that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm's length standard, so would result in double taxation;
- will increase compliance costs;
- will apply to firms with a low BEPS risk; and
- has no international precedent.

Only two submitters wrote in favour of the proposed cap. However, the proposal did attract positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.

Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".

Allowable debt levels

The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand ("deductible debt"). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer's assets (generally, debt up to 60 percent of the taxpayer's assets is allowable).

The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest-bearing debts (a "non-debt liability adjustment"). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

General reaction

Several submitters indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

A number of other submitters argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

Stakeholders' views displayed no clear pattern. Two big accounting firms agreed with the proposal while two others disagreed. Similarly, of the three major stakeholder groups who submitted on the proposal, one supported and two opposed the change.

Deferred tax

To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future;
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

Further consultation

Following Cabinet decisions in July 2017, officials are planning to undertake further public consultation on outstanding policy issues, technical design details and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Related-party interest rates

We have identified five mutually exclusive options to the address the problem of excessive interest rates on related-party debts.

Option 4 (administrative guidance) is a non-regulatory option. The other options for change involve changing New Zealand's tax legislation.

Option 1: Interest rate cap (discussion document proposal)

As described in section 2.5.

Option 2: Restricted transfer pricing

Under a restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
  - That the loan has no exotic terms that are generally not seen with third-party lending
  - That the loan is not subordinated
  - That the loan duration is not excessive
  - That the debt level of the borrower is not excessive.

The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign

parent.

This restricted transfer pricing rule would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable.

This option was developed following consultation to address some of the concerns raised by submitters; however, it has not itself been subject to consultation.

Option 3: Adopt EBITDA-based rule (OECD recommended approach)

This option would involve limiting the amount of interest deductions a taxpayer is allowed with reference to their earnings (specifically, their profits before deductions for interest, depreciation and amortisation are taken into account, also known as their EBITDA). This new approach would completely replace the thin capitalisation rules, becoming the new method for limiting interest deductions for taxpayers with international connections.

This approach would constrain the tax effectiveness of highly priced debt, since it directly limits interest deductions rather than limiting the amount of debt; a taxpayer with highly priced debt would be more likely to exceed their EBITDA limit and face interest denial.

Almost all submitters did not support the adoption of an EBITDA-based rule.

Option 4: Administrative guidance

This option would involve Inland Revenue issuing administrative guidance on how it will assess the risk of related-party lending transactions – similar to what has recently been released by the Australian Taxation Office (ATO) (discussed below).

Under this option, related-party loans with certain features (such as having an interest rate in line with the interest rate facing the borrower's foreign parent) would be given a low risk rating and be unlikely to be challenged by Inland Revenue. Taxpayers with higher interest rates would be more likely to have their related-party loan investigated.

Several submitters suggested this option be adopted in place of the interest rate cap. They argued that it would provide certainty for taxpayers who desired it, but taxpayers who value certainty less would be free to breach the guidelines.

Option 5: Status quo (ordinary transfer pricing)

This option would involve continuing to price related-party debt under the transfer pricing rules. As discussed above, the Government proposed strengthening these rules in the discussion document *BEPS – transfer pricing and permanent establishment avoidance.* Many submitters argued that this should be sufficient to address any concerns over related-party interest rates.

Relevant experience from other countries

The ATO has released draft guidelines regarding the interest rates of cross-border related-party loans.[1] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

Allowable debt levels

We have identified three mutually exclusive options relating to setting the allowable debt level under the thin capitalisation rules.

The options (other than the status quo) involve changing New Zealand's tax legislation.

Option 1: Proceed with non-debt liabilities adjustment (as proposed in the discussion document)

As described in section 2.5.

Option 2: Proceed with non-debt liabilities proposal excluding deferred tax

Under this option, a taxpayer's deferred tax would be ignored for the purposes of the non-debt liability adjustment. That is, a taxpayer's allowable debt level would be set with reference to the result of the formula: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Of submitters who supported the proposed non-debt liability adjustment in principle, this was the preferred option.

Option 3: Status quo (do not proceed with non-debt liabilities adjustment)

Under this option, maximum deductible debt levels would continue to be calculated under the thin capitalisation rules with reference to assets, ignoring non-debt liabilities.

As mentioned in section 2.5, this was the preferred option of some submitters.

Relevant experience from other countries

Australia has thin capitalisation rules that are broadly similar to New Zealand's. Australia's rules currently require a non-debt liability adjustment, but deferred tax is carved-out. That is, Australia's rules are consistent with option 2.

[1] ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions, PCG 2017/D4.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible;
- *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way;
- *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible;
- *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible; and
- *Sustainability* – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

Efficiency, fairness and sustainability are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these three criteria.

3.3 What other options have been ruled out of scope, or not considered, and why?

No options were ruled out of scope.

Section 4: Impact Analysis

	Option 1 (interest rate cap)	Option 2 (restricted transfer pricing)	Option 3 (EBITDA-based rule)	Option 4 (administrative guidance)	Status quo
Efficiency and neutrality	+ Option 1 will provide a strong limit on related-party interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains. However, for some firms the interest rate allowed under the cap may be too low, which lowers the efficiency benefits.	++ Option 2 will provide a reasonably strong limit on related-party debt interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains.	**0** Option 3 will provide an effective limit on all interest expenses (including related-party interest expenses). However, it also increases the uncertainty of returns on New Zealand investment, since whether or not interest is deductible turns on a taxpayer's EBITDA, which can be very variable.	+ Some taxpayers would benefit from the certainty provided by the administrative safe harbour. However, for taxpayers willing to exceed the safe harbour, this option is no different than the status quo – excessive interest rates on related-party debt would still be possible.	**0**
Fairness and equity	++ Option 1 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	++ Option 2 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	**0** On the one hand, option 3 would be somewhat effective at preventing excessive interest rates. On the other hand, it could result in interest denial for firms with very conservative interest rates and debt positions (say, for example, if a taxpayer is in loss).	**0** Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. For taxpayers willing to exceed the administrative safe, harbour this option is no different to the status quo.	**0**
Efficiency of compliance	++ Option 1 would reduce compliance costs for many taxpayers – the allowable interest rate on related-party debt would be set on a clear objective factor (the credit rating of the foreign parent). However, in some cases – where the non-resident parent has no credit rating – compliance costs will stay the same or could potentially increase.	+ Option 2 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo)	**0** Compliance costs in some instances would reduce under option 3, as there would be fewer transfer pricing disputes about related-party debt. However, an EBITDA-based rule would be a fundamental shift in our interest limitation rules – taxpayers and agents would have to come to grips with an entirely new regime.	+ Option 4 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo).	**0**

Efficiency of administration	++ Option 1 would avoid the need for potentially complex and expensive disputes over whether the interest rate on related-party debt is set appropriate.	++ Option 2 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. For the remaining taxpayers, the restrictions (e.g. striking out exotic terms) would simplify the transfer pricing analysis.	+ Option 3 would reduce administration costs because there would be less need to review and challenge related-party loans under transfer pricing.	+ Option 4 would reduce the need to review the interest rates of taxpayers utilising the safe harbour.	**0**
Sustainability	+ Option 1 would apply to taxpayers that have structured their affairs to strip the maximum profits out of New Zealand; however, it could also affect the interest rates of less aggressive taxpayers.	++ Option 2 should generally only affect taxpayers with more aggressive debt structures.	**0** Option 3 could result in interest deduction denial even if a taxpayer has conservative debt levels.	+ Option 4 would not prevent firms from achieving excessive interest rates on related-party debt.	**0**
Overall assessment	+	++ **Recommended option**	**0**	+	**0**

Key:

++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Allowable debt levels

	Option 1 (non-debt liability adjustment)	Option 2 (adjustment with no deferred tax)	Status quo
Efficiency and neutrality	+ Option 1 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, submitters have argued that in some instances deferred tax (a type of non-debt liability) does not represent real liabilities; to the extent this is correct, reducing allowable debt levels in relation to these liabilities could hamper efficiency.	+ Option 2 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, this option carves out all types of deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option would allow some taxpayers to have too high a debt level.	**0**
Fairness and equity	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, submitters have argued that in some instances deferred tax does not represent a real liability. To the extent this is correct, including deferred tax in the non-debt liability adjustment could be seen as unfair.	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, this option excludes all deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option will not treat taxpayers in the same situation the same.	**0**
Efficiency of compliance	**0** Neither option will have a significant impact on compliance costs. The result of both options is just a change to how the existing thin capitalisation calculations are carried out. However, there may be some one-off compliance costs if the changes mean taxpayers breach their thin capitalisation limits and, as a result, decide to restructure their borrowing.		**0**
Efficiency of administration	**0** Neither option has a significant impact on administrative costs. Thin capitalisation calculations are carried out by taxpayers – this change has no substantive impact on Inland Revenue.		**0**
Sustainability	+ Both options similarly target firms with debt levels that are too high relative to their levels of equity and are therefore well targeted. Firms with low levels of debt, or with reasonable levels of debt relative to equity, will be largely unaffected by either option.		**0**
Overall assessment	+	+	**0**

Key: ++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Interest limitation

We consider that option 2 – developing a restricted transfer pricing approach – is the best option to limit interest expenses in relation to inbound related-party debt.

Following consultation and further analysis, we consider that if the Government pursued the interest rate cap (option 1), adjustments would be needed to the original discussion document proposal which would make it more complex. For example, to address some of the concerns expressed by submitters, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

The difficulty is, however, that simply relying on transfer pricing, as suggested by some submitters, will not achieve the desired policy outcomes. It is clear that the international consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. In addition, as noted in section 2.5, commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

Accordingly, we consider that the restricted transfer pricing rule is the best approach. Like the interest rate cap, it will ensure the policy objective – ensuring there is a robust mechanism for determining the interest rates for inbound related-party debt; however, since the restricted transfer pricing rule has more flexibility (compared to the interest rate cap – the other option that would most effectively achieve the policy objective) it is both more efficient and fairer.

Owing to the time available (and since it was developed subsequent to the initial consultation), this option has not been subject to consultation with stakeholders. This modification will address many, but not all of, submitters' concerns – it is still a departure from using ordinary transfer pricing. Nevertheless, we expect that it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur frequently because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

Allowable debt levels

At this stage, we do not have a preference between option 1 (non-debt liability adjustment as originally proposed) and option 2 (non-debt liability adjustment with deferred tax carve-out). Option 3 (status quo) is not preferred.

Both options 1 and 2 have similar impacts in terms of efficiency and fairness (and have no significant impacts in terms of compliance and administration costs). The non-debt liability adjustment in option 1 is potentially too extensive because of the inclusion of *all* types of deferred tax, but, on the other hand, the adjustment in option 2 is too narrow because of the exclusion of all deferred tax.

We consider that the best approach is to recommend neither options 1 or 2 at this stage, but instead consult further with stakeholders on whether there is another feasible option (since this is a minor technical detail, more consultation on this matter is feasible). For example, it might be possible to identify deferred tax liabilities that are the least likely to result in a future tax payment, and restrict the carve-out of deferred tax to just that identified group.

5.2 Summary table of costs and benefits of the preferred approach

Related-party interest rates

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40m per year	Medium
Regulators	Administration costs: There will be a one-off cost to Inland Revenue in developing guidance on how the new rules will operate.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40m per year	Medium
Non-monetised costs	Administration costs	Low	High
Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Reduction in compliance costs for firms that utilise safe harbour.	Medium	High
Regulators	Revenue: Tax collected will increase. Administration costs: Reduction in costs for ensuring related-party interest rates are appropriate.	Approximately $40m per year Medium	Medium High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40m per year	Medium
Non-monetised benefits	Compliance and administration cost reduction	Medium	High

Allowable debt levels

While a preferred option is not recommended, the costs and benefits of any option that is selected will be similar

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40–50m per year (depending on option)	High
Regulators			
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40–50m per year	High
Non-monetised costs			

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Tax collected will increase.	Approximately $40–50m per year (depending on option)	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40–50m per year	High
Non-monetised benefits			

5.3 What other impacts is this approach likely to have?

As discussed above, allowing BEPS through interest deductions is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take use interest deductions to reduce their New Zealand (and possibly worldwide) tax liability is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders. It is something that is fundamental to the tax system itself, which all of the stakeholders already discussed have an interest in preserving.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Implementation of both reforms (relating to related-party interest rates and allowable debt level) will be given effect through a combination of legislation and Inland Revenue administrative guidance. The legislative changes proposed will be progressed (subject to Cabinet approval) as part of a BEPS taxation bill to be introduced in late 2017. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin*.

In relation to the allowable debt level proposal, we will consult further with stakeholders on whether a preferred option can be identified. The Minister of Finance and Minister of Revenue will make the final decision on which option should be progressed (option 1, option 2, or a potential new option) following this consultation.

These reforms are expected to apply from income years beginning on or after 1 July 2018, subject to legislation progressing to enactment before this date.

Some submitters on the discussion document argued that transitional relief or grandparenting should be provided to give taxpayers sufficient lead-in time to restructure their affairs if necessary. We consider that the planned application date of 1 July 2018 is sufficiently prospective because:

- the interest rate proposal applies only to related-party transactions (which are more easily altered compared to transactions with third-parties); and
- in relation to the allowable debt level proposal, debt and asset levels under the thin capitalisation rules can be measured as at the end of the relevant income year, meaning taxpayers would have until at least 30 June 2019 to rearrange their affairs.

In addition, in response to consultation, we propose that advanced pricing agreements

(APAs) existing prior to the application date of these changes will be grandparented.

Once the proposals are implemented, Inland Revenue will be responsible for the ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

6.2 What are the implementation risks?

There is the risk that the relevant transfer pricing legislation could contain unintended errors or have unintended consequences. However, this risk can be efficiently managed by way of remedial amendments.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. Inland Revenue closely monitors the tax affairs of New Zealand's largest companies (which are, in general, the affected population of these proposals). For example, Inland Revenue currently collects data from these firms on their debt levels (including levels of related-party debt) through its International Questionnaire. This will allow how the proposals have impacted debt levels and related-party interest payments to be analysed.

More generally, Inland Revenue is considering the appropriate level of information that should be collected to support the proposed rules for all the BEPS measures being implemented. Any additional information may be collected via a disclosure statement that must be provided to Inland Revenue or it may be collected using existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTTP involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, following enactment, any changes identified as necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – transfer pricing and permanent establishment avoidance

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to prevent permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue investigate uncooperative multinationals. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Some large multinationals are currently using tax arrangements which allow them to report low taxable profits in New Zealand despite carrying on significant economic activity here.

3. In March this year, the Government released a discussion document called *BEPS – Transfer pricing and permanent establishment avoidance* to consult on proposals to combat these arrangements. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

4. Submissions and workshops with the private sector were used to refine the proposals and better target them at the BEPS activities we are concerned about, whilst reducing the compliance costs and other unintended impacts on taxpayers engaging in ordinary, commercial dealings.

5. We recommend that nearly all of the proposals in the discussion document proceed, subject to some changes following consultation. The most significant changes made to the original proposals as a result of consultation were:

- The proposed permanent establishment (PE) avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

- Clarification of the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

- The proposal to require disputed tax to be paid earlier should not proceed. This is because we consider it to be unnecessary in light of the current "use of money" interest rate regime.

6. These changes are likely to be welcomed by submitters and do not reduce the overall effectiveness of the proposed reforms.

7. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

8. The forecast tax revenue from implementing the transfer pricing and PE avoidance measures is $25m in 2018/19 and $50m per annum from 2019/20. Some of this revenue has already been included in the Budget 2017 forecasts.

Background

9. In February this year, Cabinet agreed to release the Government discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (CAB-17-MIN-0041 refers).

10. The discussion document, which was released in March 2017, consulted on proposals to combat aggressive tax strategies which allow some multinationals to report low taxable profits in New Zealand despite carrying on significant economic activity here. These strategies involve:

- ***Tax structuring***: In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (a permanent establishment or "PE") in New Zealand. However, non-residents can structure their affairs to avoid such a taxable presence, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).

- ***Creating enforcement barriers:*** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.

11. The OECD and the G20 are also concerned about these kinds of BEPS strategies, and have recommended measures to address them in their 15 point BEPS Action Plan. These include:

- a widened definition of "permanent establishment" for double tax agreements (DTAs), to counter PE avoidance (however this will only be included in a DTA if both countries agree); and

- updated transfer pricing guidelines, to counter profit shifting.

Comment

12. We have developed a package of proposed tax law changes to combat transfer pricing and PE avoidance. The main elements of the proposed reform package are:

- The introduction of a new PE avoidance rule that will prevent multinationals from structuring their operations to avoid having a PE in New Zealand where one exists in substance.

- Stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income.

- Stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities. We also

propose shifting the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length, and extending the time bar (the period of time which Inland Revenue has to reassess a taxpayer) from four years to seven years for transfer pricing.

- A range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues). These are similar to some of the administrative powers provided under the UK and Australia's Diverted Profit Taxes but New Zealand's administrative measures are more targeted at the practical barriers faced by tax investigators as they will only apply when a multinational does not cooperate with a tax investigation.

13. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment to address issues that Inland Revenue has identified when investigating multinationals.

Private sector consultation

14. 15 submitters provided written submissions on the discussion document. The Treasury and Inland Revenue also met with six of these submitters to discuss their submissions.

General reaction

15. Overall, most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more certain and better targeted.

16. Two of the 15 submitters welcomed the proposals as a positive step by the Government to ensure that all large multinationals are paying their fair share of tax.

17. The other 13 submitters were tax advisors or represent multinationals that could be negatively affected by the proposals. Their submissions were critical of some of the measures.

18. Some submitters argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. As noted in the accompanying covering Cabinet Paper (*Tax measures to prevent base erosion and profit shifting*), there will be additional tax and compliance costs for some investors but these additional costs will mostly be borne by taxpayers engaging in BEPS activities and the overall benefits to New Zealand of addressing BEPS outweigh these costs.

19. As expected, most of the submitters opposed the administrative proposals to increase Inland Revenue's powers to investigate multinationals. However, we consider these new powers are necessary to ensure Inland Revenue can effectively enforce the new rules. These new powers include:

- Expanding Inland Revenue's ability to request information that is held by a related group member offshore. Submitters considered this proposal could unfairly penalise a New Zealand entity that may not be able to get the information from their multinational group members. However, we consider it is unacceptable for Inland Revenue's investigations to be frustrated because a multinational group fails to provide information that is under its control.

- Shifting the burden of proof for transfer pricing onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length. Submitters considered Inland Revenue had information regarding comparable transactions and should bear the burden of proof. However, shifting the burden of proof is consistent with the fact that the taxpayer holds the relevant information on their own transfer pricing practices. The burden of proof is already on the taxpayer for other tax matters and is also on the taxpayer for transfer pricing matters in most other OECD and G20 countries, including Australia. Because most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries, the additional compliance costs from this change are not expected to be substantial.

- Extending the time bar (the period of time which Inland Revenue has to adjust a taxpayer's transfer pricing position) from four years to seven years for transfer pricing. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have a special seven year time bar for transfer pricing) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Changes made as a result of consultation

20. In response to submissions, we have updated the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

21. Many submissions focused on when the PE avoidance rule would apply. Submitters considered the proposal outlined in the discussion document applied too broadly and could have unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

22. We consider the PE avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

23. Submitters also pointed out that the OECD has updated their model DTA to address PE avoidance and New Zealand is currently in the process of adopting this into some of our tax treaties by signing the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* and through negotiating new tax treaties. We agree that the domestic law PE avoidance rule will only be necessary when the relevant tax treaty does not yet include the OECD's new recommendation and propose narrowing the application of rule accordingly.

24. The PE avoidance rule would apply notwithstanding the relevant DTAs (that don't yet include the OECD's new model PE rule). We consider that this is acceptable for two reasons:

- The OECD's commentary to their model DTA contemplates that countries can adopt anti-avoidance rules and states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. An existing example of this is New Zealand's General Anti-Avoidance Rule which explicitly overrides our DTAs to allow New Zealand to combat tax avoidance arrangements. The PE avoidance rule would be a specific anti-avoidance rule, which would also be consistent with the principle in the OECD's commentary.

- The UK and Australia have already implemented similar PE avoidance rules in their domestic laws which override their DTAs and their treaty partners have not challenged this.

25. Another major point raised by submitters was the need to clarify the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

26. Other significant changes made as a result of consultation were:

- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.

- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money" interest rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay tax that is in dispute.

27. The above changes will make the rules more certain and better targeted and are likely to be welcomed by submitters.

28. We also recommend widening the scope of the original proposal to deem an amount of income to have a New Zealand source under our domestic legislation if we have a right to tax the income under a DTA. The rule proposed in the discussion document was limited to income covered by the PE and royalty articles of our DTAs. We should extend the rule to all types of income that we can tax under a DTA – as Australia does. This ensures we can exercise a taxing right that we have negotiated under a DTA. We will consult further on this wider proposal in the next round of consultation.

29. These recommended changes will not affect the originally forecast revenue from implementing the transfer pricing and PE avoidance measures, which is $25m in 2018/19 and $50m per annum from 2019/20 (some of this revenue has already been included in the Budget 2017 forecasts).

30. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

Agency consultation

31. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, publicity

32. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

33. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

34. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

35. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing the overall effectiveness of the proposed reforms.

3. **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure their businesses to avoid having a PE (taxable presence) in New Zealand.

4. **Agree** to expand and strengthen the rules for taxing New Zealand-sourced income by:

   - deeming certain amounts of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA;

   - introducing an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source; and

   - addressing a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand, including where the income is not subject to New Zealand tax by operation of a DTA.

5. **Agree** to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. This involves amending New Zealand's transfer pricing rules so that:

   - they disregard legal form if it does not align with the actual economic substance of the transaction;

   - they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;

   - the legislation specifically refers to arm's length conditions;

- they refer to the latest OECD transfer pricing guidelines as guidance for how the rules are applied;

- the new legislation codifies the requirement for large multinationals to provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative;

- the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased to seven years (in line with Australia);

- the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters); and

- in addition to applying to transactions between related parties, the transfer pricing rules will also apply when non-resident investors "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.

6. **Agree** to strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation by amending the Tax Administration Act 1994 to allow Inland Revenue to:

   - more readily assess the multinational's tax position based on the information available to Inland Revenue at the time;

   - collect any tax owed by a member of a large multinational group from any wholly-owned group member, provided the non-resident fails to pay the tax itself;

   - use section 17 of the Tax Administration Act 1994 to request information that is held offshore by another group member of the large multinational group;

   - use section 21 of the Tax Administration Act 1994 to deem an amount of income to be allocated to a New Zealand group member or PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand sourced income (currently the existing power only applies in respect of deductible payments); and

   - impose a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty).

7. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

8. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

9. **Agree** that the results of the decisions in recommendations 3-6 and 8 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – transfer pricing and permanent establishment avoidance rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

There are international concerns about multinationals not paying their fair share of tax. This is because some multinationals use base erosion and profit shifting (BEPS) strategies to report low taxable profits in New Zealand and other countries in which they operate. These BEPS strategies include arrangements between related parties which shift profits out of New Zealand (usually into a lower taxed jurisdiction). They also include arrangements which are designed to ensure New Zealand is not able to tax any income from sales here despite there being a physical presence in New Zealand in relation to the sales. These particular BEPS strategies are known as transfer pricing and permanent establishment (PE) avoidance. Finally, Inland Revenue faces administrative difficulties in investigating large multinationals.

Proposed Approach

How will Government intervention work to bring about the desired change? How is this the best option?

The proposed approach is to adopt the package of measures outlined in the Government discussion document *BEPS – transfer pricing and permanent establishment avoidance (March 2017)*, with some changes resulting from consultation, as the measures will:

- ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;
- stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and
- make it easier for Inland Revenue to investigate such multinationals.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit by receiving an additional $50 million of revenue per annum. Compliant businesses will benefit because the multinationals involved in transfer pricing and PE avoidance activities will no longer be able to achieve a competitive advantage. Also, the measures will support voluntary compliance by protecting the integrity of the tax system.

Where do the costs fall?
Multinationals which currently engage in BEPS activities will face a medium level of compliance costs. These taxpayers may choose to transition into more tax compliant agreements which will require restructuring costs; or they may apply for advance pricing agreements (APAs). However, the majority of multinationals are compliant and should not be materially affected by the proposals.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is a risk that foreign companies investing in New Zealand will view the proposals as complex and onerous, incentivising them to remove their existing personnel from New Zealand or to cease operating in New Zealand altogether. However, most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is limited certainty of evidence in relation to the problem of transfer pricing and PE avoidance arrangements. This is because such activities are often not directly observable in the absence of specific audit activity. However, Inland Revenue is aware of about 16 cases involved in these types of BEPS arrangements which are currently under audit. While there are only 20 New Zealand-owned multinationals that earn over the threshold for some of the main proposals (over EUR €750 million of consolidated global revenue), the European Union (EU) has estimated that there may be up to 6,000 multinationals globally

that do. However, we do not know how many of these global multinationals operate in New Zealand.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed *the BEPS – transfer pricing and permanent establishment avoidance rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – transfer pricing and permanent establishment avoidance rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

Evidence of the problem

Our analysis has been limited somewhat by our inability to assess the exact size of the transfer pricing and PE avoidance structures in New Zealand. In common with BEPS activities generally, transfer pricing and PE avoidance is difficult to quantify as tax avoidance is often not directly observable. We consider that, while most multinationals are compliant, there is a minority that engage in transfer pricing and PE avoidance. Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not addressed. Furthermore, as New Zealand endorses the Organisation for Economic Co-operation and Development's (OECD) *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan), there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Range of options considered

Our analysis of options has been primarily constrained by New Zealand's double tax agreements (DTAs). Under its DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

Assumptions underpinning impact analysis

The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of transfer pricing and PE avoidance arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs, and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

Responsible Manager (signature and date):
Carmel Peters Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to the aggressive tax planning strategies used by some multinationals to pay little or no tax anywhere in the world. This outcome is achieved when multinationals exploit gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In 2013, the OECD published its BEPS Action Plan which identified actions needed to address BEPS (including transfer pricing and PE avoidance), set deadlines to implement these actions, and identified the resources needed and the methodology to implement these actions. In 2015, the OECD released its final package of recommended actions for countries to implement to counter BEPS.

If no action is taken to counter transfer pricing and PE avoidance arrangements, multinationals that are currently engaging in these types of arrangements will be able to continue, and the number of these types of avoidance cases will continue to increase.

New Zealand's BEPS work

New Zealand is a supporter of the OECD/G20 BEPS project to address international avoidance and is advancing a number of the OECD/G20 BEPS recommendations.

In September 2016, the Government released the BEPS discussion document *Addressing hybrid mismatch arrangements*. In March 2017, the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*; along with the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*.

The *BEPS – Transfer pricing and permanent establishment avoidance* discussion document consulted on the Government's proposal to introduce a new set of tax rules to counter BEPS activities involving transfer pricing and PE avoidance. Many of the proposals follow the OECD's BEPS Action Plan recommendations (such as updating our transfer pricing legislation to align with the OECD's new transfer pricing guidelines).

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework ensures the tax system is not generally used to deliver incentives or encourage particular behaviours.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge is to ensure that our tax rules are up to date and result in multinational firms paying a fair and efficient amount of tax in New Zealand. Base protection measures, such as transfer pricing and PE rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

New Zealand's PE rules

New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules in conjunction with our DTAs. Under our DTAs, New Zealand is generally prevented from taxing a non-resident's business income unless the non-resident has a PE in New Zealand. This is the case even if that income has a source in New Zealand under our domestic legislation.

In general, New Zealand can only tax a non-resident multinational group on its sales here if both of the following conditions are met:

- The multinational group has a sufficient taxable presence in New Zealand. This means the group must operate in New Zealand either through a New Zealand-resident subsidiary (in which case the subsidiary is taxable on its income) or through a PE of a non-resident group member. A PE is basically a place of business of the non-resident, but it also includes an agent acting for the non-resident.
- Where a multinational operates in New Zealand through a PE of a non-resident group member, some of the non-resident's net profits from its sales can be attributed to its taxable presence here. This involves determining:
    - The amount of the non-resident's gross sales income which can be attributed to its PE here; and
    - The amount of the expenses which can be deducted from that income to determine the net taxable profits in New Zealand.

The non-resident must also have a sufficient taxable presence in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

New Zealand's transfer pricing rules

"Transfer pricing" refers to the use of cross-border payments between associated entities such as a parent and a subsidiary. Transfer pricing rules are therefore concerned with

determining the conditions, including the price (and therefore the tax liability), for transactions within a multinational group resulting in the allocation of profits to group companies in different jurisdictions.

New Zealand's transfer pricing legislation was first introduced in 1995 and is largely focused on the legal form of the transaction and adjusting the consideration that is paid to an arm's length amount (which can be zero). Due to the increased complexity and tax planning of cross-border intra-group trade over the last 22 years, New Zealand's existing transfer pricing rules are unable to adequately address some types of profit shifting.

General anti-avoidance rule (GAAR)

New Zealand also has a general anti-avoidance rule (GAAR) which effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. However, the GAAR is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own.

2.3 What is the policy problem or opportunity?

The problem of transfer pricing and PE avoidance

Some multinational companies operating in New Zealand exploit deficiencies in the current international tax system (both in New Zealand and abroad) by using transfer pricing and PE avoidance strategies to report low taxable profits in New Zealand despite carrying out significant economic activity here. Transfer pricing and PE avoidance can lead to unfairness and the substitution of low-taxed investors for tax-paying investors. This has the potential to reduce national income while doing little or nothing to reduce the overall pre-tax cost of capital to New Zealand or increase the overall level of investment. It also distorts the allocation of investment by favouring foreign investors who set out to game the system.

Transfer pricing avoidance

One of the major strategies used by multinationals to shift profits out of New Zealand and reduce their worldwide tax bills is transfer pricing. Related parties may agree to pay an artificially high or low price for goods, services, funding, or intangibles compared to the "arm's length" price or conditions that an unrelated third party would be willing to pay or accept under a similar transaction. By manipulating these transfer prices or conditions, profits can be shifted out of New Zealand and into a lower-taxed country or entity.

PE avoidance

Some multinationals reduce their New Zealand tax liability by structuring their affairs to avoid a PE arising, despite carrying on significant activity here.

Impacted population

These rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Many of the proposed measures will apply only to multinational groups with over EUR €750 million of consolidated global revenue. While there are only 20 New Zealand-owned multinationals that earn this much, the EU has estimated that there may be up to 6,000

multinationals globally that do. However, we do not know how many of these global multinationals operate in New Zealand.

Transfer pricing and PE arrangements in New Zealand

Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not strengthened. Furthermore, as New Zealand endorses the OECD's BEPS Action Plan, there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Inland Revenue's judgement is that the transfer pricing and PE proposals can expect to add $50 million a year of revenue to the forecasts. This $50 million per year estimate relates to the fact that the proposals will make it more difficult to avoid tax under the transfer pricing and PE rules and easier to find and assess any remaining avoidance cases. This should reduce future avoidance arrangements and free up investigator resources. The changes will also result in more revenue being able to be assessed from any multinationals which continue to use transfer pricing or PE avoidance arrangements.

2.4 Are there any constraints on the scope for decision making?

Our analysis of options has been primarily constrained by New Zealand's DTAs. Under our DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. The OECD guidance permits departure from this only in respect of tax avoidance. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

2.5 What do stakeholders think?

Submissions on the discussion document

The Government received 16 submissions on the discussion document from key stakeholders.[1] We also met with six of the main submitters to discuss their submissions in more detail.

Many submitters strongly opposed the proposals that increased Inland Revenue's power to investigate large multinationals. Others argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented.

However, most submitters accepted the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. Some submitters even welcomed the proposals as a positive step by the Government to ensure multinationals pay their fair share of tax.

Further consultation

Following Cabinet decisions in July 2017, we are planning to undertake further public

[1] Most of the submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

consultation on outstanding policy issues, technical design details, and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Officials have identified four mutually exclusive options to address the problem:

- Option 1 – Status quo
- Option 2 – MLI and the OECD's transfer pricing guidelines
- Option 3 – Diverted profit tax
- Option 4 – Discussion document proposals (as amended through consultation)

Option 1 is the only non-regulatory option. The other options involve implementing an international agreement or changing New Zealand tax legislation.

Option 1: Status quo

This option would retain the existing tax rules for multinationals (as described in the sections above). Under this option, Inland Revenue would continue trying to enforce the existing rules and/or apply the GAAR to challenge tax avoidance arrangements.

Option 2: MLI and the OECD's transfer pricing guidelines

Option 2 is to rely on the combination of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI)[2] and the OECD's transfer pricing guidelines without amending our domestic law. Under this option, any PE avoidance issues would be addressed under the OECD's new PE definition in the MLI, and any transfer pricing issues would be addressed by applying the OECD's new transfer pricing guidelines.

Option 3: Diverted profits tax

Option 3 is to adopt a diverted profits tax (DPT). A DPT is a separate tax on the "diverted profits" that arise from transfer pricing and PE avoidance. It is levied at a penal rate, compared with income tax, and has greatly enhanced assessment and collection powers. Both the UK and Australia have already implemented a DPT to target multinationals engaging in BEPS strategies. DPTs are intended to incentivise taxpayers to pay the correct amount of income tax under the normal rules rather than to raise revenue by themselves.

Option 4: Discussion document proposals (as amended through consultation)

This option involves adopting the package of measures proposed in the discussion document, with some changes resulting from consultation. The discussion document proposals have taken certain features of a DPT and combined them with the OECD's BEPS measures and some domestic law amendments to produce a package of measures that is tailored for the New Zealand environment. The intention is that this approach would be as effective as a DPT in addressing transfer pricing and PE avoidance in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. Under this option, we would introduce:

- an anti-avoidance rule that will prevent multinationals from structuring their operations

[2] The MLI allows countries to quickly and efficiently implement a number of the OECD's BEPS Action Plan measures that can only be implemented through changes to DTAs, without having to bilaterally renegotiate their existing DTAs.

to avoid having a PE (a taxable presence) in New Zealand where one exists in substance;

- stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities; shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length; and extend the time bar for transfer pricing from four years to seven years;
- stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income; and
- a range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation (such as allowing Inland Revenue to request information that is held by an offshore group member).

Consultation

These four options were identified prior to consultation. The discussion document proposed the adoption of a package of reforms combining elements of a DPT with the OECD's recommendations and some domestic law amendments (option 4). The discussion document discussed the status quo (option 1) and the DPT (option 3). Some submitters proposed that the better approach would be to sign the MLI and apply the OECD's transfer pricing guidelines without amending our domestic law (option 2).

In response to consultation we have refined the proposals so they are better targeted at BEPS arrangements with less compliance costs and fewer unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

Significant changes made as a result of consultation were:

- More narrowly targeting the PE avoidance rule at avoidance arrangements (we will consult further on how best to achieve this).
- Clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.
- The PE avoidance rule will only apply where an applicable DTA does not include the OECD's widened PE definition (as in cases where the OECD's new PE definition is included, the proposed PE avoidance rule will be unnecessary).
- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money interest" rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay any tax which has been assessed.

The above changes are likely to be welcomed by submitters.

Evidence from Australia's reforms

Australia's recent experience updating their transfer pricing laws (in 2013) and introducing a new Multinational Anti-Avoidance Law (MAAL) demonstrates the effectiveness of tax reforms

to address PE avoidance and transfer pricing issues.

Australia's MAAL came into effect on 11 December 2015 and prevents multinationals from structuring their affairs to avoid having a PE in Australia. It is very similar to our proposed PE avoidance rule.

As of 4 June 2017, the Australian Tax Office (ATO) had identified 221 taxpayers they believed to be shifting profits to a non-resident group member resident in a low-tax jurisdiction. Of these 221 taxpayers, the ATO has cleared 102. Furthermore, since the MAAL was introduced, 18 companies with PE avoidance structures have restructured their affairs to bring their sales onshore – and a further 11 are currently working with the ATO to restructure.

According to the ATO, as a result of the introduction of the MAAL, an additional AUS$6.4 billion worth of assessable income will now be reported in Australia. This translates into $100 million a year in additional tax revenue for Australia.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible;
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible;
- Neutrality – the tax system should bias economic decisions as little as possible;
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way; and
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality, and fairness impacts without some increase in compliance costs and so there are some trade-offs that were, and continue to be, considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

Two options were ruled out of scope due to their radical nature, namely:

- cancel New Zealand's DTAs; and
- prevent multinationals from selling products in New Zealand if they were suspected of involvement in BEPS activities.

The former would harm New Zealand exporters and outbound investors. The latter would not only harm New Zealand consumers (as they would no longer be able to import certain goods), but it would also violate New Zealand's trade agreements.

Section 4: Impact Analysis

	Option 1: Status quo	Option 2: MLI and the OECD's transfer pricing guidelines	Option 3: Diverted profit tax	Option 4: Discussion document proposals (as amended through consultation)
Efficiency of compliance	0	- Option 2 imposes increased compliance costs on taxpayers as a result of applying the MLI and the new transfer pricing guidelines.	- - Option 3 imposes ongoing compliance costs on taxpayers as it requires them to provide information or concede transfer pricing outcomes in transfer pricing audits.	- Option 4 imposes increased compliance costs on taxpayers as they will be required to conform to the additional administrative measures. See below for further details.
Efficiency of administration	0	0 We do not expect there will be increased administrative costs under this option as the reforms largely change the way some taxpayers self-assess the income and deductions they report to Inland Revenue.	- We expect there will be increased administrative costs under this option as a DPT is a separate tax from an income tax.	0 We do not expect there will be increased administrative costs under this option. The proposed administrative measures should also make it easier for Inland Revenue to investigate uncooperative multinationals. See below for further details.
Neutrality	0	+ Option 2 will remove some of the tax benefit of currently observed transfer pricing and PE avoidance opportunities in New Zealand. See below for further details.	+ Option 3 will remove the tax benefit of currently observed transfer pricing and PE avoidance opportunities involving New Zealand. However, it may have a negative impact on investment certainty for taxpayers.	+ + Option 4 will remove the tax benefit of all currently observed transfer pricing and PE avoidance opportunities involving New Zealand. See below for further details.
Fairness and equity	0	+ Option 2 has some fairness benefits as it ensures that some taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	0 Option 3 has some fairness benefits as it ensures that taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	+ Option 4 has the most fairness benefits as it ensures that all taxpayers able to use observed transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others.
Sustainability	0	+ Option 2 will remove some, but not all, of the current transfer pricing and PE establishment opportunities involving New Zealand.	+ Option 3 will remove current transfer pricing and PE establishment opportunities involving New Zealand. See below for further details.	+ + Option 4 will remove current transfer pricing and PE establishment opportunities involving New Zealand and is well-targeted at the problems that have been observed by Inland Revenue in New Zealand.
Overall assessment	Not recommended	Not recommended	Not recommended	Recommended

Key:

++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

Option 2 (MLI and the OECD's transfer pricing guidelines)

- **Neutrality:** The effect of this option will be limited as the MLI will not cover many of our DTAs and New Zealand's current transfer pricing legislation does not allow us to apply some of the new transfer pricing guidelines.
- **Fairness and equity:** While option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements.

Option 3 (Diverted profits tax)

- **Fairness and equity:** While option 2 has some fairness benefits, it also has some significant fairness detriments owing to its penal tax rate, reduced taxpayer rights, and wide scope. Further, a DPT could also impact on the perception of the fairness of New Zealand's tax system for multinationals investing into New Zealand.
- **Sustainability:** Compared to the other options it would provide less certainty for, and impose more compliance costs on, taxpayers.

Option 4 (Discussion document proposals (as amended through consultation))

- **Efficiency of compliance:** It is also highly likely that a number of taxpayers will choose to restructure their affairs and/or apply APAs.
- **Efficiency of administration:** The proposals may place a higher demand on Inland Revenue's transfer pricing team and more transfer pricing specialists may be required to deal with this.
- **Neutrality:** This option will ensure multinationals engaged in BEPS activities are not tax-advantaged over more compliant domestic and non-resident businesses. This will provide some efficiency gains.

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 4 (discussion document proposals (as amended through consultation)) is the best option to combat transfer pricing and PE avoidance.

Option 4 will improve the neutrality of New Zealand's tax system by eliminating the ability for multinationals to engage in aggressive transfer pricing and PE avoidance schemes to receive tax benefits. Option 4 will:

- ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;
- stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and
- make it easier for Inland Revenue to investigate such multinationals.

Option 4 will also improve the equity and fairness of New Zealand's tax system. Multinationals engaging in BEPS activities are currently able to structure their affairs to receive unintended tax benefits placing them at a competitive advantage over more compliant multinationals or domestic companies. As a result, these more compliant multinationals and domestic companies end up suffering a greater tax burden. Option 4 will therefore ensure that the tax burden is shared more equally among taxpayers.

While option 4 will impose additional tax and compliance costs on some taxpayers, it is important to note that some of the measures will only apply to large multinational groups with over EUR €750 million of consolidated group turnover. Submitters on the discussion document argued that the imposition of higher tax payments may make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, as a number of like-minded countries throughout the OECD are undertaking similar BEPS measures, we believe that any impacts on foreign direct investment into New Zealand will not be material and that implementing the proposals in option 4 remains in New Zealand's best economic interests (see further discussion in section 5.3 below).

Option 1 (status quo) was preferred by a number of submitters to the discussion document. However, retaining the current rules would mean that those multinationals engaging in aggressive transfer pricing and PE avoidance structures would be able to continue, and the number of these types of avoidance cases would continue to increase. While New Zealand has a GAAR (see above in section 2.2), it is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own. This is because applying the GAAR often leads to resource-intensive court cases and it may be difficult to show that certain avoidance structures fail the Parliamentary contemplation component of the GAAR.

Option 2 (MLI and the OECD's transfer pricing guidelines) was the option suggested by many submitters. However, we consider that adopting the OECD's recommendations on their own (without corresponding domestic amendments) would not effectively address the issue of transfer pricing and PE avoidance. First, New Zealand's existing transfer pricing legislation does not contemplate an ability to apply some important aspects of the new OECD's transfer pricing guidelines. This means that Inland Revenue would only be able to

apply the guidelines to the extent that our current domestic rules allow. Domestic law changes would likely be needed to adequately address the issue. Second, while option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements. This is because the MLI will only apply where both countries choose to adopt it – and many of New Zealand's trading partners do not intend to adopt it. It is therefore important that New Zealand adopt its own PE avoidance measure to supplement the MLI, otherwise there would still be a gap for multinationals to exploit. Third, the OECD's BEPS measures do not address issues specific to New Zealand, such as issues with our current source rules and the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes). Option 3 (diverted profits tax) is not recommended. This option would provide less certainty for, and impose significant compliance costs on, taxpayers. This is because a DPT is a separate tax at a much higher rate than the standard company tax rate and includes stringent enforcement mechanisms. This means an investor may find themselves being charged a much higher rate of tax (plus interest and penalties) that can be difficult to challenge or credit against prior year losses or taxes charged by other countries. This increased risk and uncertainty may reduce their willingness to invest in New Zealand (compared to more certain investments elsewhere).

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: increased costs understanding the rules and applying them to transactions and structures for multinationals which currently engage in BEPS activities. Such taxpayers may choose to restructure which will involve compliance costs and the demand for APAs may increase.	Medium. However, they should only affect multinationals currently engaged in BEPS activities.	Medium
	Revenue	**$50 million per year**	Low*

Regulators	Administrative costs: Inland Revenue staff, particularly investigators and transfer pricing specialists, need to develop their knowledge of the proposals.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Revenue	**$50 million per year**	Low*
Non-monetised costs	Compliance costs Administrative costs	Medium Low	Medium High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Tax payable: we are confident of collecting a significant amount of revenue from the proposals. Reduced administrative costs: More powers to both request multinationals' offshore information and to investigate uncooperative multinationals should make investigating these types of BEPS arrangements easier.	**$50 million per year** Low	Low* High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	**$50 million per year**	Low*
Non-monetised benefits	Reduced administrative costs Improved voluntary compliance by supporting the integrity of the tax system in a high profile area.	Low Low	Low Low

*Note that the evidence for the $50 million figure is a conservative estimate made in light of the behavioural uncertainty associated with introducing transfer pricing and PE avoidance rules together with the fact that the full extent of these types of avoidance arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be significantly higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?
During consultation on the discussion document, some submitters raised concerns that adopting the proposed measures would have a detrimental impact on New Zealand being an attractive investment destination. In particular, these submitters were concerned that the proposed measures introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, thereby reducing GDP and lowering employment levels. The higher tax payments and compliance obligations resulting from these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, at the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded countries throughout the OECD. Given this, we believe any impacts on foreign direct investment into New Zealand will not be material and implementing these measures remains in New Zealand's best economic interests. It is also highly unlikely that foreign companies will remove their existing personnel from New Zealand as a result of these proposals. Most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?
Yes, option 4 (to adopt the package of measures in the discussion document) conforms to Government's 'Expectations for the design of regulatory systems'.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin* (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018.

One exception is a grandparenting rule that exempts from application of the rules all advance pricing agreements (APAs) existing prior to the application date.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider the planned application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we plan on meeting with taxpayers and preparing detailed guidance materials.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation, and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

When the MAAL was introduced in Australia, 18 companies restructured their affairs to bring their sales onshore (and a further 11 are currently working with the ATO to restructure). We envisage a similar response to our proposals whereby a number of taxpayers will restructure their affairs to report their sales in New Zealand. We also expect more taxpayers to apply for APAs as a result of the new transfer pricing rules. However, it will be difficult to assess the true impact of the transfer pricing proposals.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is significantly unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – addressing hybrid mismatch arrangements

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to address the problem of hybrid mismatch arrangements. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

3. The OECD, as part of its base erosion and profit shifting (BEPS) Action Plan, published in late 2015 its final report on hybrid mismatch arrangements. This report recommended that countries enact a comprehensive set of rules to neutralise the benefit of hybrid mismatch arrangements affecting their tax base.

4. The UK has legislated the OECD recommendations into their domestic law and Australia is committed to do the same. The EU has also issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

5. The OECD recommendations will not apply to the vast majority of taxpayers. They will not apply to purely domestic firms. They apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of the OECD recommendations is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

6. The Government released a discussion document in September 2016 called *Addressing Hybrid Mismatch Arrangements* which proposed that the OECD recommendations be adopted in New Zealand and asked for feedback on how that should best be done. Since receiving submissions to this document, officials have engaged stakeholders in targeted consultation on specific design issues relating to the proposal. Consultation has resulted in some of the proposals being modified, such as a proposed exclusion from the rules for New Zealand businesses that operate offshore only through a simple branch structure. Nevertheless, many taxpayers affected by these proposals will still oppose them. Some would prefer to see a targeted approach, which would only tackle hybrids that have already been observed in New Zealand.

7. However, in order to send the clear message that using hybrid mismatch arrangements should not produce a tax advantage, we are recommending that Cabinet agree to a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New Zealand context. To do otherwise may simply encourage the ongoing use of hybrids not covered by any targeted proposal. Other issues raised through the consultation process, and which are likely to attract the most comment (such as the application of the rules to foreign trusts) are set out in paragraphs 24-38 of this paper.

8. We are further recommending that hybrids rules be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Background

BEPS

9. New Zealand's BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan,. Its final package of reports was released in October 2015. The Action Plan is a multifaceted approach intending to encourage countries to close many (but not all) of the avenues multinational companies currently use to reduce their worldwide tax liability, and to improve the information available to governments when they deal with multinational companies, without changing the fundamental principles for the taxation of international trade and investment.

10. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

Hybrid mismatch arrangements

11. Hybrid mismatch arrangements are a significant base erosion and profit shifting (BEPS) strategy used by some multinational companies to pay little or no tax anywhere in the world on some or all of their income. They are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation.

12. One way in which this double non-taxation can arise is through a payment being deductible for a payer in one country but not included as taxable income for the payee in the other country. Another way double non-taxation can arise is by way of a single payment being deducted against different income streams in two countries.

13. Double non-taxation of this kind is difficult to deal with, because it can be achieved even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues. It is often difficult to determine which of the countries involved has lost tax revenue through the use of a hybrid mismatch arrangement, but there is undoubtedly a reduction of worldwide tax paid.

The OECD's response

14. The OECD has made a number of recommendations as to how countries can improve their domestic rules to prevent mismatches arising and neutralise their effect when they do arise. These recommendations relate to Action 2 of the OECD/G20 BEPS Action Plan: Neutralising the Effects of Hybrid Mismatch Arrangements.

15. The OECD recommends two kinds of rules. The first are rules specifically designed to reduce the likelihood of hybrid mismatches arising. The second are "linking rules", which apply to payments that give rise to a deduction in more than one country, or which give rise to a deduction in one country but are not taxed as income in another country due to a hybrid mismatch. These generally only apply to:

- arrangements between related parties (25% or more commonly owned) or control groups (50% or more commonly owned); or
- structured arrangements - generally, arrangements between non-associated parties which intentionally exploit such mismatches.

16. These linking rules are divided into "primary" and "secondary" responses. Primary responses have precedence, with secondary responses being used if the country that has the primary right does not have hybrid rules. This primary/secondary structure is important for ensuring that all hybrids with a connection to New Zealand are effectively countered irrespective of where the counterparty is based.

17. The OECD has also developed an additional BEPS Action 2 report that makes a number of recommendations as to how countries can deal with the problem of branch mismatch arrangements which is closely related to the hybrid mismatches issue.

Other countries

18. The UK has introduced into its domestic law rules that reflect a broad adoption of the OECD recommendations. Australia has proposed to do the same and, as part of its 2017 Budget, committed to introduce rules that are effective by 1 January 2018 or six months following Royal assent.[1] The EU has issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules by 1 January 2020. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

Hybrids discussion document

19. On 6 September 2016, the Government released a discussion document entitled "Addressing hybrid mismatch arrangements" seeking feedback on proposals to address hybrid mismatch arrangements in line with the OECD recommendations [CAB-16-MIN-0442].

20. 20 submissions were received on the discussion document. Most submitters accepted the need for some hybrid rules, with some submitters expressing support for New Zealand to take action in line with the OECD hybrids package, subject to various provisos, including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. The majority of submissions argued that we should only implement rules to counter hybrid mismatches actually observed in New Zealand, rather than the full suite of OECD recommendations.

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[1] As set out in paragraph 59, Australia has indicated that it is unlikely to implement OECD recommendation 5 at this stage, but may do so in the future if integrity concerns arise.

Comment

Implementing the full OECD hybrids package

21. As set out in the cover Cabinet paper (*Tax measures to counter base erosion and profit shifting*), we are recommending that Cabinet agree to a comprehensive implementation of the OECD's proposed solutions to the hybrid and branch mismatch problem, , even though there was limited evidence of some of the structures being used in New Zealand. We are of the view that the OECD proposals are in New Zealand's best interests, as enacting these recommendations will improve fairness, reduce harmful distortions in investment patterns, increase tax revenue, and will also address the risk of taxpayers using new hybrid mismatch opportunities if only the more common techniques are addressed initially.

22. In making this recommendation, we recognise that these proposals involve considerable complexity, which will not generally be welcomed by those taxpayers affected. However, we are comfortable that there are a number of factors that outweigh these concerns:

- We are proposing to modify the OECD recommendations when it is appropriate to do so for the New Zealand context. Examples are ensuring New Zealand companies with simple foreign branch structures are not caught by the rules (see "application of hybrids rules to foreign branches" below), not applying the rules to purely domestic firms, and not introducing rules when an adequate New Zealand provision already exists.

- We are recommending that officials continue to consult on a few particular issues that have the potential to ease the compliance costs of the proposals before we make a final decision on them under Cabinet delegated authority. These consist of elective options which would in effect allow existing hybrids to be treated as simple equity investments.

- Despite the necessary complexity, the underlying principle is clear – using hybrid mismatches as a tax-efficient means of inbound, outbound or conduit investment is not appropriate.

- We are recommending that relevant parties be consulted on exposure drafts of key aspects of the legislation. This is intended to facilitate workable legislation that is understandable to those applying it.

- In almost all cases, the complexity will be optional. Taxpayers can avoid having to deal with these rules by undertaking simple debt or equity funding.

23. Some of the other more significant issues relating to this proposal are set out below. Those are followed by a brief explanation of each of the OECD recommendations and the principles behind them. The appendix contains a series of detailed aspects of the proposals that we are also seeking Cabinet's agreement to. These details have been consulted on with interested parties, and are consistent with the general recommendations set out below.

Significant issues

Foreign trusts

24. As set out in the cover Cabinet paper, we are recommending that foreign trusts be included within the scope of these rules in circumstances where their treatment outside of New Zealand means income of the trust is not included in a tax calculation anywhere in the world. This is not because they are foreign trusts, but because in those circumstances they are "reverse hybrids" according to the OECD recommendations (see the discussion on OECD Recommendation 5.2, below). The same rule would equally impose tax on New Zealand limited partnerships that fit within the reverse hybrids definition.

25. We are aware that foreign trusts have recently had a new set of disclosure rules apply to them following the 2016 Government Inquiry into Foreign Trust Disclosure Rules. In this respect, adding another regulatory regime to the industry now is unfortunate timing. To reflect the fact that these trusts have recently undergone significant compliance costs, and to give the foreign trust and limited partnership industries more time to understand the implications of the proposed rules, we are recommending a delayed effective date for New Zealand reverse hybrids of 1 April 2019.

Application of hybrid rules to foreign branches

26. The way in which the OECD recommendations are written would in some circumstances deny a New Zealand company the ability to offset a loss from its foreign branch against its New Zealand income. This is an issue that some submitters have been very concerned about.

27. We have made various modifications to the OECD recommendations to address this issue, including clarifying that taxpayers who have simple offshore branch structures do not present a hybrid mismatch problem and so are not covered by the rules.

Imported mismatches

28. OECD recommendation 8 suggests countries include an "imported mismatch" rule when implementing hybrid and branch mismatch rules. Imported mismatch rules apply when the New Zealand resident is not directly involved in the hybrid mismatch, but the benefit of a mismatch is "imported". Some submitters on the discussion document viewed this particular recommendation as over-reach, highly complex and impractical.

29. To address these concerns, we recommend that the introduction of the imported mismatch rule be different for "structured" and "unstructured" arrangements. Structured arrangements are deliberately entered into to obtain a tax advantage, so should be implemented at the same time as the rest of the hybrid rules. By contrast, unstructured arrangements are ones where the New Zealand benefit is not the primary reason for entering into the arrangement. We recommend that the unstructured rule has a delayed implementation date of 1 January 2020. By this date, we expect that the EU countries, the UK, and Australia will all have hybrid rules. Delaying the implementation of the unstructured rule until those countries have similar rules will reduce the costs involved in complying with the rule in New Zealand because, by that time, multinationals that are also operating in those countries should already be complying with their equivalent rules, and also because payments

to those countries will not be subject to the imported mismatch rule at all. More details regarding the imported mismatch rule are contained later in this paper.

Over-taxation by reason of the imposition of NRWT

30. The OECD recommends that countries apply the hybrid rules without regard to any withholding tax collected on the relevant payments. In situations where New Zealand imposes non-resident withholding tax (NRWT) on an interest payment that is also denied a deduction under the hybrid rules, there may be over-taxation.

31. As far as our officials are aware, Australia is not planning on departing from the OECD approach. An argument for this approach is that in the majority of cases taxpayers can simply switch to simpler structures and arrangements and be subject to only single taxation. The OECD approach is also less complicated. Nevertheless, there has been an argument from some submitters that the hybrid rules should be modified in New Zealand so as to remove this potential over-taxation for taxpayers that choose to remain in hybrid structures.

32. We recommend that in the case of a hybrid financial instrument, there needs to be further consideration of the possibility of letting taxpayers treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We recommend that Cabinet delegate the authority to determine the appropriateness of such an approach to us to decide after receiving further advice. For hybrid arrangements other than financial instruments, we are less concerned about the imposition of NRWT. Although there may be some over-taxation, in many cases this will simply be a timing issue.

Grandparenting for certain instruments issued by banks to the public

33. We recommend that there be an exception to the rules for certain hybrid instruments ("hybrid regulatory capital") issued by banks and insurance companies either directly or indirectly to third party investors, in partial satisfaction of the capital requirements imposed on those companies by regulators (such as the Reserve Bank and its Australian equivalent, APRA). We recommend that such instruments issued before the date of the discussion document release (6 September 2016) should not be subject to the hybrid rules until the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

34. This grandparenting date is different to the date proposed in Australia, which is 8 May 2017 (the day before their Federal Budget). We consider differing from Australia is justified in this case. The Australian Government had made public the fact that it was considering how such instruments should be taxed, and did not make an announcement until its 2017 Budget. In New Zealand the hybrids discussion document released on 6 September stated that such instruments would be subject to the hybrid rules. To grandparent instruments issued after the New Zealand discussion document may be seen as encouraging taxpayers to enter into aggressive structures after the government has stated an intention to change the rules but before that change is enacted. We are wary of creating an expectation that such arrangements will be grandparented.

Opaque election for foreign hybrid entities

35. The private sector has proposed that a New Zealand investor in a foreign hybrid entity be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand to remove the hybridity and put that entity outside the scope of the rules. Our initial view is that

excluding simple branch structures from the rules, and the ability of hybrid participants to restructure their arrangements, may make such an election redundant. Nevertheless, we have asked officials to continue their consideration of how such an election may work in practice, including whether the costs of administering it for what may be a relatively small group are justified. We recommend that Cabinet delegate to us the authority to decide on the appropriateness of an opaque election.

Application of rules to branch mismatch arrangements

36. Consultation on branch mismatches has taken place but has not been as comprehensive as that for the remainder of the hybrid proposals. In part this is because such mismatches are less significant for New Zealand, and in part because the OECD draft report on branches was released at around the same time as the New Zealand discussion document, and the proposal was therefore less well developed. Nevertheless, we recommend that New Zealand implement rules that are consistent with the OECD recommendations on branch mismatches (this is also consistent with the approach that has been taken by the UK and which we understand will be taken by Australia). Branch mismatches arising from foreign branch losses are a double non-taxation risk and to leave them out of these proposals would expose the tax base to future risk. The remainder of the branch mismatch concerns addressed are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

De minimis rule

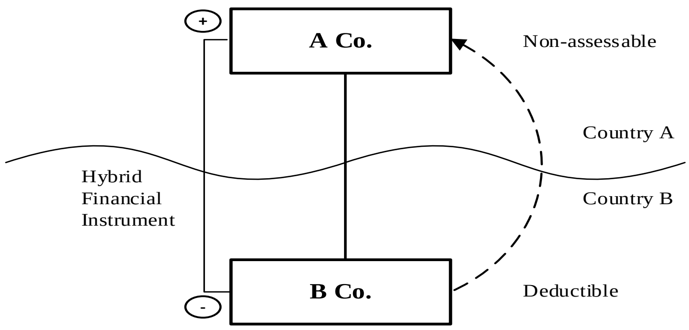
37. We recommend that there be no general de minimis for the hybrid rules. We believe that a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules. This means that any de minimis would likely be ineffective in practice because the other country would still counter the hybrid mismatch using their secondary response right. Also, our proposals will ensure that simple branch structures (the most likely beneficiaries of a de minimis) are not within the scope of the rules.

38. We do however recommend that there should be specific de minimis rules for reverse hybrid entities established in New Zealand (see paragraphs 55-57).

OECD recommendations

Hybrid financial instrument rules (Recommendations 1 and 2)

39. The following diagram illustrates a typical hybrid financial instrument issued between related parties A Co and B Co.



40. Double non-taxation arises in this situation because the payment on the hybrid financial instrument is deductible (as interest) in Country B but not taxable (because it is treated as an exempt dividend) in Country A.

41. OECD recommendation 2 is a specific recommendation that countries should amend their domestic law so that dividend payments that are deductible to the payer (B Co) should be treated as ordinary income for the payee (A Co).

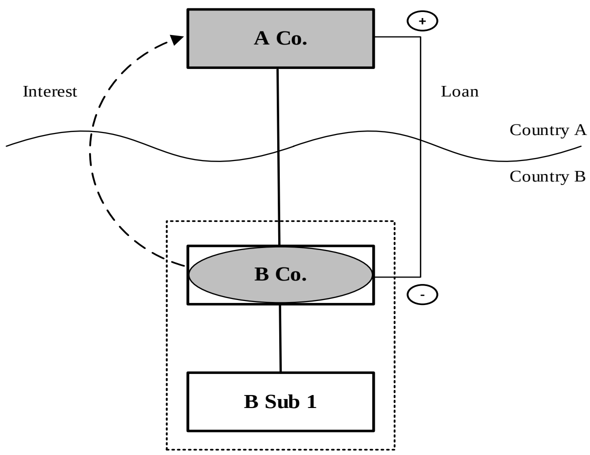
42. New Zealand already has a rule that switches off the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. We recommend that this rule be expanded to also apply if the foreign payer receives tax benefits similar in nature to a deduction.

43. We also recommend introducing rules in line with the general principles of OECD recommendation 1. This means that, in relation to hybrid financial instruments that are structured or between related parties, we should deny a New Zealand payer a deduction for the payment (when New Zealand is Country B) to the extent it is not taxed to a non-resident payee. It is in respect of this aspect of recommendation 1 that we are considering the election to treat interest payments as dividends. In addition, when New Zealand is Country A and Country B does not have hybrid rules, we should tax the New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit.

44. We also recommend that when there is a timing mismatch that allows a deduction to be claimed in one country in a period that is significantly earlier than the period in which income is included in the other country, the rules above should also apply.

Disregarded hybrid payments rule (Recommendation 3)

45. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor (Country A) but opaque for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the hybrid entity.



46. The interest payment by B Co is deductible in the hybrid entity country (Country B) but disregarded in the investor country (Country A) because Country A sees B Co as being part of A Co and therefore not capable of making a payment to itself. However, as the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can

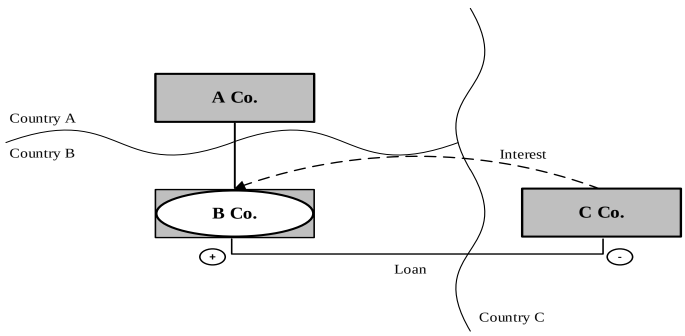
therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

47. We recommend introducing rules in line with the general principles of OECD recommendation 3 in order to prevent double non-taxation arising from a payment by a hybrid entity. We recommend that, when New Zealand is Country B and payments are deductible here but are disregarded for tax purposes in Country A (and the payments are part of a structured arrangement or made to a person in the same control group), we should deny a deduction for the payment. Similarly, if New Zealand is Country A and the non-resident payer in Country B has not been denied a deduction for the payment under similar rules, we should tax the receipt by the New Zealand payee as ordinary income.

48. We recommend that deductions denied and income included by the above rules should be reversible to the extent that the hybrid entity has earned "dual inclusion income", being income taxed in both Country A and Country B. This is because this dual inclusion income is included as income in both countries so the corresponding deduction should also be allowed in both countries. The dual inclusion income can be earned in the same period as the payment is made, in an earlier period, or in a later period.

Reverse hybrid rules (Recommendations 4 and 5)

49. A reverse hybrid entity is an entity which is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the reverse hybrid.



50. If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co.

51. We recommend introducing rules in line with the general principles of OECD recommendation 4 to prevent double non-taxation arising from a payment to a reverse hybrid. We recommend that, when New Zealand is Country C, the New Zealand payer be denied a deduction for a payment to a reverse hybrid if the payment would have been taxed if paid directly to the investor (A Co). This rule would only apply when the payer, payee and investor are all in a control group or the payment is part of a structured arrangement.

52. OECD recommendation 5.1 is that countries should change their domestic law so that they tax residents on income not taxed in another country due to its being earned by a reverse hybrid. In other words, when New Zealand is Country A, we should tax A Co on the income of B Co if Country B does not tax it (because it treats B Co as transparent for tax purposes).

53. We recommend that New Zealand should have rules that are in line with the general principles of recommendation 5.1 and other international tax principles. New Zealand already has controlled foreign companies (CFC) rules that in most cases would prevent a reverse hybrid entity mismatch outcome from occurring when a New Zealand resident is the investor (A Co). We recommend that Cabinet delegate authority to us to determine whether our current CFC rules should be enhanced to deal with any forms of reverse hybrid income not currently dealt with, in line with the general principles of recommendation 5.1.

54. OECD recommendation 5.2 is that countries should change their domestic law so that they tax income which is earned by a reverse hybrid entity established in their country. So, when New Zealand is Country B, we recommend introducing rules in line with the general principles of this recommendation. As set out in the cover Cabinet paper and in paragraphs 24-25, this will require amendments to existing law regarding New Zealand limited partnerships and foreign trusts, which can be reverse hybrid entities depending on the tax treatment in the investor country.

55. In regards to limited partnerships, we recommend taxing the partnership income of a non-resident partner if they are in a control group with the partnership and not taxed on their share of the partnership income because their jurisdiction views the income as earned by the partnership as a separate taxpayer from the partner. This rule will only apply if the limited partnership has total foreign-sourced income of greater than $10,000 or 20% of its total income. This de minimis rule, and the corresponding one for foreign trusts in the following paragraphs, is consistent with the recently-enacted de minimis rule for foreign sourced income of look-through companies.

56. In regards to foreign trusts, we recommend taxing the foreign-source trustee income of the trust, provided that the non-resident settlor and trust are all in a control group. Many family trusts would meet this requirement. Foreign source trustee income will only be taxed if the non-resident settlor is not taxed on the trustee income in their residence country simply because the income is earned by the New Zealand trustee rather than the settlor directly. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income.

57. We also recommend taxing the foreign-source beneficiary income of a non-resident beneficiary of a foreign trust if they are not taxed on the income in their residence country because that country views the income as earned by the trustee and not the beneficiary. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income, and the non-resident beneficiary is part of a control group with the trust/trustee. In relation to both beneficiary and trustee income, tax would only be imposed if there was no-one else in the same control group required to include that income in their taxable income.

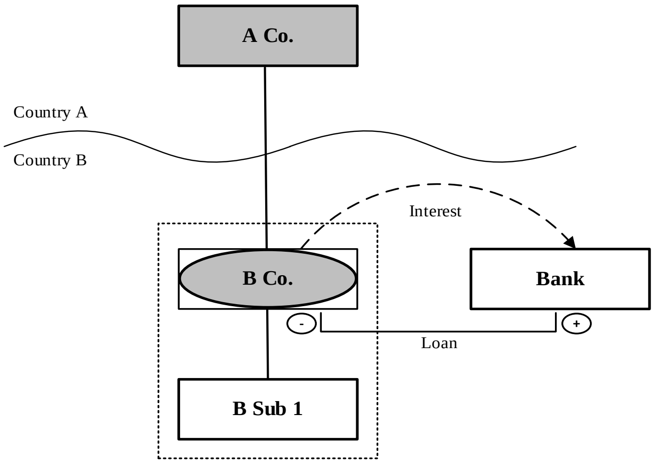
58. OECD recommendation 5.3 is that countries should consider improvements to record keeping and disclosure rules for tax transparent entities established in their country. Following the 2016 Government Inquiry into Foreign Trust Disclosure Rules, the disclosure rules for foreign trusts have been enhanced. New Zealand is regularly reviewed by the OECD to ensure that we are meeting international standards in this area. The Government will

continue to work with the OECD and make improvements to disclosure rules as necessary to ensure compliance with best practice.

59. We note that Australia has indicated that it is unlikely to implement any of recommendation 5 at this point – this is largely because they see their existing rules as adequate. However, they have reserved the right to do so in the future if integrity concerns arise. We are not as confident that our existing rules in relation to reverse hybrids are adequate to prevent mismatches from occurring. As set out above, we are concerned that leaving 'gaps' in our rules exposes our tax base to risks that can be mitigated by following all of the OECD's recommendations.

Hybrid entities – double deductions (Recommendation 6)

60. In addition to being capable of generating a deductible/non-inclusion hybrid mismatch, a hybrid entity can also be used to generate a double deduction mismatch. A diagram illustrating this possibility follows, where B Co is the hybrid entity.



61. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment can offset income earned by B Sub 1, which is in a tax consolidated group with B Co. This is a double non-taxation outcome because a single payment has been deducted against different income in two countries.

62. In Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand [CAB-17-MIN-0164]. This means that, when New Zealand is Country A, the deductions in B Co would not flow back to New Zealand if it is possible for that deduction to also offset Country B income that does not flow back to A Co (in this case, the income of B Sub 1).

63. Nothing in this paper is inconsistent with that specific decision. However, as mentioned in paragraph 26-27, we are recommending a slightly narrowed approach to the OECD recommendation 6, whereby simple structures involving a New Zealand company with only an offshore branch would not fall within the scope of the rules.

64. We also recommend implementing a rule that would, when New Zealand is Country B, disallow the losses of a foreign-owned New Zealand hybrid entity or branch when the country of the owner (Country A) has not denied the loss.

65. As with the recommendation 3 rule, denial of a deduction under the recommendation 6 rule should be reversed to the extent that the hybrid entity has dual inclusion income, whether in the current period, an earlier period, or a later period.

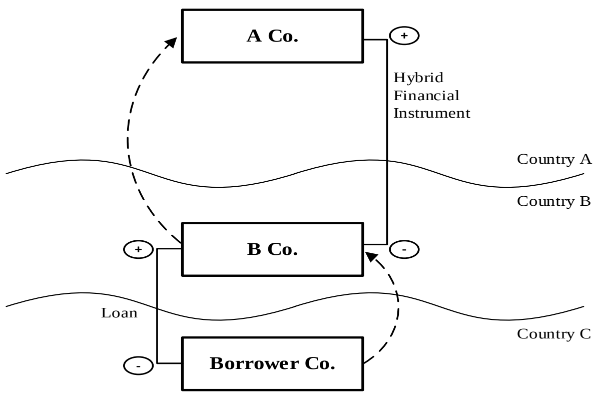
Dual resident entities (Recommendation 7)

66. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. Expenditure incurred by a company that is a resident of two different countries can potentially be used in each country to offset non-dual inclusion income, which is income taxed only in that country. This would achieve the same double deduction outcomes that hybrid entities can produce under recommendation 6 (above).

67. New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

Imported mismatches (Recommendation 8)

68. As set out in paragraphs 28-29, we recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment that funds another payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



69. In this example, New Zealand is Country C. The loan between A Co and B Co generates a deduction in Country B, with no corresponding income inclusion in Country A. This is a double non-taxation outcome. However, this tax mismatch is not counteracted because neither Country A nor Country B has hybrid rules. The tax benefit of the A/B mismatch helps fund the seemingly benign arrangement between B Co and the New Zealand entity (Borrower Co).

70. The imported mismatch rule would require New Zealand, as Country C, to deny a deduction for interest payments from Borrower Co to B Co to the extend they do not exceed the payments under the hybrid financial instrument between B Co and A Co. This is an integrity measure that prevents New Zealand's other hybrid rules from being circumvented.

Without this rule, businesses in Country A can simply avoid our proposed rules by going from A to C via B.

71. We recommend that the imported mismatch rule applies to both structured arrangements that are designed to produce an imported mismatch outcome, and unstructured arrangements within a control group. However, because unstructured arrangements may not be deliberately contemplated, we are recommending a delayed implementation for those arrangements until more countries, the EU countries in particular, have hybrids rules in place.

Agency consultation

72. The consultation on this project has been explained in the cover Cabinet paper. Briefly, there have been two rounds of consultation: one on the proposals in the discussion document; and a further round with selected submitters on branch mismatches and some of the detailed aspects set out in this paper.

Financial implications

73. The proposed hybrid rule denying double deductions for foreign hybrid entities is estimated to increase tax revenue by $50 million per year from the 2019-20 year onwards. These amounts are already included in the forecasts as per Budget 2017 (CAB-17-MIN-0164).

74. In addition, the proposed approach to grandparenting certain hybrid instruments as discussed at paragraphs 33-34 is expected to generate a total of $71 million over four years which is not currently included in the forecasts. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

75. The combined revenue impact of all proposals is estimated as:

$ million – increase / (decrease)							
Vote Revenue	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**	**2021 /22**	**2022/23 and out years**
Foreign hybrid entity double deductions (already included in forecast)	0	0	25	50	50	50	50
Hybrid instruments – grandparenting (new adjustment to forecasts)	0	0	19	19	19	14	0
Total revenue effect	**0**	**0**	**44**	**69**	**69**	**64**	**50**

Human rights, administrative impacts, legislative implications, publicity

76. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

77. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

78. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

79. We recommend that Cabinet:

1. **Agree** that for payments under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:

    a. to deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (OECD recommendation 1 primary rule); and
    b. if a non-resident payer has not been denied a deduction for the payment under similar rules, to tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (OECD recommendation 1 defensive rule).

2. **Agree** to expand New Zealand’s current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (OECD recommendation 2).

3. **Agree** that for payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognised under the tax law in the payee country because the payment is disregarded under that law:

    a. to deny a deduction for the payment if made by a New Zealand payer (OECD recommendation 3 primary rule);
    b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, to include the payment in ordinary income of the New Zealand resident (OECD recommendation 3 defensive rule);
    c. to allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against income that is included as income in both relevant countries (“dual inclusion income”).

4. **Agree** to deny a New Zealand payer a deduction in relation to payments made to a reverse hybrid entity in the same control group as the payer or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid entity (OECD recommendation 4).

5. **Agree** that New Zealand should tax the income of a reverse hybrid established in New Zealand (such as a foreign trust or a limited partnership) to the extent that:

   a. the reverse hybrid income is not subject to tax in another jurisdiction (OECD recommendation 5.2); and
   b. the total foreign sourced income of the reverse hybrid exceeds the greater of $10,000 or 20% of the total income of the reverse hybrid.

6. **Agree** to the following in relation to double deduction outcomes produced by branches and hybrid entity structures:

   a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branch if there is another entity in that foreign country whose income is capable of being offset against the losses of the hybrid entity or branch and that income is not taxable in New Zealand (modified OECD recommendation 6 primary);
   b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (OECD recommendation 6 defensive); and
   c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

7. **Agree** to deny a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income (OECD recommendation 7).

8. **Agree** to deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, except to the extent that the payment is made to a country that has hybrid mismatch rules (OECD recommendation 8).

9. **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.

10. **Agree** that the effective date of the rule relating to unstructured imported mismatches (part of recommendation 8 above) should be delayed until 1 January 2020.

11. **Agree** that the application of the rule relating to New Zealand reverse hybrids (recommendation 5 above) should be for income years beginning on or after 1 April 2019.

12. **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:

    a. issued to satisfy the regulatory capital requirements imposed by New Zealand or Australian law;
    b. directly to, or are traceable to, issues to the public; and
    c. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

13. **Note** that the fiscal consequences of agreeing to recommendation 12 above is set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

14. **Agree** to the detailed design proposals set out in the appendix to this paper.

15. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on further detail of these proposals, or to amend the detail in the appendix, provided any such decisions are not contradictory with the principles set out in recommendations 1 to 12, without further reference to Cabinet.

16. **Agree** to delegate authority to the Minister of Finance and the Minister of Revenue to make final policy decisions on the following policy issues without further reference to Cabinet:

    a. whether New Zealand's controlled foreign company (CFC) rules should be modified to include as attributable foreign income all income of a reverse hybrid entity which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is treated as fiscally transparent in that country (OECD recommendation 5.1);
    b. whether New Zealand can and should include a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes; and
    c. whether, the payer under a hybrid financial arrangement for which a deduction is denied, should be allowed to treat the payment as a dividend for purposes of both (but not only one of) the non-resident withholding tax and the imputation credit rules.

17. **Agree** that the results of the decisions in recommendations 1-16 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Appendix

List of detailed design decisions

	OECD Recommendations 1 and 2
1.	A person who receives a payment which is deductible to the payer in another country will not be entitled to the benefit of any imputation credit attached to the payment.
2.	When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency, the deduction denied will take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes, and any net income from the instrument including any foreign currency fluctuations will be non-taxable.
3.	When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the taxpayer will not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.
4.	To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee entity under another country's controlled foreign company (CFC) regime, the payer will be allowed a deduction for the payment.
5.	If a person holds a FIF interest as part of a share repo arrangement, that person will be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest.
6.	If a person holds New Zealand shares as part of a share repo arrangement, where the borrower is a non-resident, the person is not entitled to the benefit of an imputation credit attached to any dividends on the shares.
7.	OECD recommendation 1 will only apply to timing mismatches if: • the mismatch arises on an instrument with a term of 3 years or more or on an instrument that has been extended to beyond 3 years; and • the lender is not accounting for the payment, for tax purposes, on a reasonable accrual basis; and • it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months

	of the end of the period in which the expenditure is incurred.
8.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.
9.	Interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.
10.	There will be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

	OECD Recommendation 3
11.	Any foreign currency fluctuations recognised for tax purposes in relation to a financial arrangement denominated in a foreign currency will be taken into account when denying a deduction to a New Zealand payer.
12.	Dual inclusion income will be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it will not include income which is protected from New Zealand tax by a foreign tax credit.
13.	For the purposes of denying a deduction for a New Zealand payer, full taxation of income under a CFC regime will prevent income being treated as not taxable to a payee and will qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.
14.	When an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that will be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible.
15.	The ability to claim a deduction in relation to a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.
16.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted.

17.	Denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules.
18.	A deduction would be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs.
19.	Where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income will be reversed in a later year when there is dual inclusion income earned through the hybrid entity.

	OECD Recommendation 4
20.	Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.
21.	Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.
22.	To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.
23.	Non-resident withholding tax will continue to be applied to payments, despite the denial of the deduction
24.	Interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

	OECD Recommendation 5.2
25.	Tax the partnership income of a non-resident partner of a New Zealand limited partnership if the non-resident partner is in a control group with the partnership and the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not by the partner.
26.	Tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that: • the beneficiary is in the same control group as the trustee; and • the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and • the income is not subject to tax as the income of any person other than

	the trustee (such as the beneficiary or settlor).
27.	Tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that: • the settlor is in the same control group as the trustee; • the settlor would be taxed on the trustee income if it held the trust assets directly; and • the income is not subject to tax as the income of any person other than the trustee.
28.	Include a de minimis so that none of the above recommendation 5.2 rules apply if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

	OECD Recommendation 6
29.	There will be a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity.
30.	A deduction will be allowed in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country
31.	Income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit.
32.	Double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch will be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
33.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.
34.	Amendments will be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are

	deducted.
35.	Denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	OECD Recommendation 7
36.	Amend existing consolidation and loss grouping rules for dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.
37.	Double deduction amounts and dual inclusion income amounts will be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
38.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred.
39.	Denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	OECD Recommendation 8
40.	When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied will ignore any foreign currency fluctuations on the instrument.
41.	Interest that is denied a deduction under recommendation 8 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules

	General design and definitional matters
42.	A coordination rule will be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.
43.	A specific anti-avoidance rule will be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.

Coversheet: BEPS - Hybrid mismatch arrangements

Advising agencies	*Inland Revenue, The Treasury*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
A tailored adoption of the OECD's BEPS Action 2 recommendations will comprehensively deal with the problem of hybrid mismatch arrangements while making modifications and variations to take into account what is appropriate for the New Zealand context. This tailored solution is sustainable and achieves gains to efficiency and fairness, while minimising compliance costs where possible. There will be a significant benefit in adopting a solution which is adopted by other countries and which will therefore be easier for multinational businesses to understand and comply with.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis. There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

Where do the costs fall?
Taxpayers that use hybrid mismatch arrangements will face a medium level of compliance costs. These may be up-front, in the form of restructuring costs to transition to more straightforward (non-hybrid) arrangements, or they may be ongoing in the case of taxpayers that keep their hybrid mismatch arrangements in place and must apply new tax rules in order to comply with the law.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is some risk of taxpayer noncompliance with the proposed rules. However, the risk of taxpayers being inadvertently caught by the proposed rules has been minimised due to the design of the preferred regulatory option which seeks to exclude the most simple offshore structures (foreign branches). More generally, the impacts have been reduced through the proposals taking into account the New Zealand context and adjusting the OECD-recommended rules as needed.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Not every type of hybrid arrangement that would be countered by the proposals has been observed in New Zealand. However, Inland Revenue is aware of some historic and current hybrid arrangements, and there is a very high likelihood there are others that relate to New Zealand and will be affected by this regulatory proposal.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the BEPS – hybrid mismatch arrangements Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS - Hybrid mismatch arrangements

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

Evidence of the problem

Our analysis has been limited somewhat by our inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand. Inland Revenue is aware of some mismatch arrangements, but the full extent of the problem is unknown. This is because evidence of the problem primarily comes from Inland Revenue's investigations staff. Under current law these staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals.

Range of options considered

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Assumptions underpinning impact analysis

The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of hybrid mismatch arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

Responsible Manager (signature and date):

Paul Kilford
Policy Manager, Policy and Strategy
Inland Revenue

12 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinational groups to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter base erosion and profit shifting (BEPS).

Hybrid mismatch arrangements

Hybrid mismatch arrangements arise when taxpayers exploit inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. The OECD's BEPS package includes Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. Hybrid mismatch arrangements are prevalent worldwide and are an important part of the base erosion and profit shifting strategies used by multinational companies. If no action is taken by the international community to counter these types of arrangements they are likely to continue to be used to avoid worldwide taxation and drive economic inefficiencies and unfairly distributed tax burdens.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations.

In September 2016 the Government released a BEPS discussion document: *Addressing hybrid mismatch arrangements* which proposed adoption of the OECD Action 2 recommendations in New Zealand and sought submissions on how that should be done. In March 2017 the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*.

As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand. This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions.

At the same time, Cabinet noted that the reforms proposed in the BEPS documents would be progressed, subject to modification in consultation, for implementation from 1 July 2018. Cabinet also noted that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later in 2017.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

Company tax and international rules

The company tax system is designed to be a backstop for taxing the personal income of domestic investors. Company tax is deducted at 28%, but New Zealand based investors can claim imputation credits for tax paid by the company when the income is taxed upon distribution at the personal level. At the same time, the company tax is designed as a final tax on New Zealand-sourced income of foreign investors and foreign-owned companies earning New Zealand-sourced income.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge in the area of international tax is to ensure that multinational firms pay a fair and efficient amount of tax in New Zealand. Anti-avoidance rules and base protection measures are important part of ensuring that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

2.3 What is the policy problem or opportunity?

The problem of hybrid mismatch arrangements

Businesses can use hybrid mismatch arrangements to create tax advantages through exploiting inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. For example, using a hybrid entity or a foreign branch, a single expense may be deducted in two different jurisdictions, potentially reducing the tax payable on two different streams of income. Another example is a payment that is tax-deductible in one jurisdiction with no corresponding taxable income in the jurisdiction where the payment is received. However it is achieved, the result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates when compared with a straightforward arrangement that is seen consistently by both relevant countries. Hybrid mismatch arrangements also have the effect of subsidising international investment relative to domestic investment, which distorts the efficiency of global markets.

Since releasing its final recommendations on hybrid mismatch arrangements, the OECD expanded the scope of BEPS Action 2 to include branch mismatches. Branch mismatch arrangements are a result of countries approaching the allocation of income and expenses between a branch and a head office in different ways. Branch mismatch arrangements can also result in a reduction in the overall taxation of a corporate group, so are similar in effect to hybrid mismatch arrangements.

It is important to note that the policy problem is limited to circumstances when global tax is reduced as a result of a hybrid mismatch. This project does not address other mechanisms that taxpayers may use to lower their global tax liability, such as the use of low-tax jurisdictions to trap income.

Hybrid mismatch arrangements in New Zealand

New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the effects of a hybrid mismatch arrangement. However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way. Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements.

New Zealand also has some specific rules in its domestic law that go some way to addressing particular recommendations made by the OECD in relation to hybrid mismatch arrangements.

Inland Revenue is aware of a significant volume of hybrid mismatch arrangements involving New Zealand. For example, the amount of tax at issue in recent litigation for a prominent type of hybrid financial instrument was approximately $300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to the most prominent hybrid entity structure results in approximately $50 million less tax revenue for New Zealand per year.

2.4 Are there any constraints on the scope for decision making?

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Consistent with the OECD approach, the analysis has been focused on arrangements between related parties or where a hybrid mismatch has been created through a structured arrangement between unrelated parties.

We have also chosen to restrict the policy thinking to cross-border activity. Purely domestic hybrid mismatches (some of which are contemplated by the OECD Action 2 final report) are outside the scope of this regulatory proposal.

2.5 What do stakeholders think?

Stakeholders

Stakeholders of this regulatory proposal are primarily taxpayers (typically multinational businesses that have hybrid mismatch arrangements) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules. The proposed rules affect only taxpayers with foreign

connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

Another stakeholder of this regulatory proposal is the OECD, which is aiming to eradicate hybrid mismatch arrangements to the extent possible. This goal can only be achieved through countries adopting hybrid mismatch rules of some kind and neutralising the mismatches that arise when different sets of rules apply to the same transaction or entity. In addition, other countries that have enacted or are proposing to enact hybrid mismatch rules (for example, Australia and the United Kingdom) will be interested in the interaction between their own hybrid mismatch rules and any rules that New Zealand introduce into law.

The Reserve Bank of New Zealand (RBNZ) is interested in the regulatory proposal to the extent that it affects bank regulatory capital.

Submissions to discussion document

There were 20 submissions made to the September 2016 Government discussion document. Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions of some variety. However, a greater number of submitters were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

Further and ongoing consultation

We have engaged in approximately a dozen workshops (with the Corporate Taxpayers Group and Chartered Accountants Australia and New Zealand) and attended various other meetings with private sector submitters (including the New Zealand Bankers' Association) in order to discuss specific design issues relating to hybrid mismatch arrangements.

We have also consulted with officials representing Australia and the United Kingdom, as well as the OECD secretariat, on an ongoing basis to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation.

We have also consulted with the Reserve Bank.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Section 3: Options identification

3.1 What options are available to address the problem?

Four options were considered in the development of this regulatory proposal. These options are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) New Zealand aligns itself with the OECD recommendations in dealing with hybrid mismatch arrangements.

None of the options (with the exception of the status quo option) are non-regulatory options. This is because our judgment is that the policy problem of hybrid mismatch arrangements cannot be addressed without changing tax rules, and that is something that can only be done through the use of legislation (as per section 22(a) of the Constitution Act 1986).

These options are what we consider other countries dealing with hybrid mismatch arrangements will consider in their policy development process. The United Kingdom and Australia can both be said to have chosen their own version of option 2. Some other countries have had rules to deal with hybrid mismatches that predate the OECD's work in this area.

Status quo: No action

This option relies on New Zealand's existing law (including the GAAR) to counter hybrid mismatch arrangements and avoids the increased compliance costs and administrative costs of the other options. The status quo option also contemplates that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to New Zealand.

Option 1: Strict adoption of OECD recommendations

The OECD recommendations as set out in its BEPS Action 2 report are a comprehensive set of principle-based rules to counteract all types of hybrid mismatch arrangements. Option 1 is to strictly adopt those recommendations as described by the OECD into New Zealand domestic law. This option would deal with the range of hybrid mismatch arrangements targeted by the OECD to the extent they are found in or affect New Zealand. It would have the advantage of interacting well with other countries that similarly adopt the OECD recommendations into their domestic law.

Option 2: Tailored adoption of OECD recommendations

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the New Zealand context. This option bears close relation to Option 1 as it involves introducing OECD-consistent hybrid rules unless there is a compelling reason to depart from the OECD approach. Thus, this option would solve the policy problem while ensuring that particular New Zealand issues are addressed.

Option 2 also recognises that there are some instances where New Zealand's existing tax laws are sufficient (or can be made sufficient with relatively minor amendment) to achieve the effect intended by an OECD recommendation.

Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid

enacting rules targeted at arrangements which are not currently seen in New Zealand.

Consultation

These four options were identified prior to consultation. The September 2016 discussion document proposed adoption of the OECD recommendations (options 1 and 2) and sought feedback on how that should be done. The document stated the Government's alternative options as option 3 and maintaining the status quo and concluded that they were not the best way forward. Consultation has affected the nature of option 2 in particular and has been helpful for options analysis generally.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible
- Neutrality – the tax system should bias economic decisions as little as possible
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality and fairness impacts without some increase in compliance costs and so there are some trade-offs that were and continue to be considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

We ruled out designing a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This is for reasons of international compatibility and to save compliance costs.

Section 4: Impact Analysis

	Status quo: No action	Option 1: Strict adoption	Option 2: Tailored adoption	Option 3: Targeted rules
Efficiency of compliance	0	- - Option 1 has a significant compliance burden because some of the OECD recommendations as drafted would not mesh well with New Zealand's existing tax laws.	- Option 2 imposes increased compliance costs on taxpayers and advisors, but is focused on reducing those costs where possible.	- Option 3 imposes increased compliance costs on taxpayers and advisors, but by its nature it reduces those costs in proposing rules that only address currently observed exploitation of hybrid mismatches.
Efficiency of administration	0	0 We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	0 We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	0 We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.
Neutrality	0	++ Option 1 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	++ Option 2 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	+ Option 3 will remove the tax benefit of currently observed hybrid mismatch opportunities involving New Zealand. This will likely provide some efficiency gains. However, other hybrid mismatch arrangement opportunities will remain available. This means that, depending on the extent to which taxpayers respond to an option 3 approach by simply moving into "uncovered" tax-efficient hybrid structures, there will still be some inefficient allocations of investment due to ongoing hybrid mismatch arrangements.
Fairness and equity	0	+ Option 1 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 2 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 3 has fairness and equity benefits as it ensures that taxpayers able to use currently observed hybrid mismatch arrangements cannot reduce their tax liability. However, this option's fairness impact depends on the behavioural effects of introducing these rules to a greater extent than options 1 and 2.
Sustainability	0	++ Option 1 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	++ Option 2 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	+ Option 3 will remove currently known hybrid mismatch arrangement opportunities involving New Zealand. However, this option's sustainability is limited. It will leave some hybrid mismatches unaddressed, which may be exploited at a later date by opportunistic taxpayers.
Overall assessment	Not recommended	Not recommended	**Recommended**	Not recommended

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 2 is the best option for addressing the problem of hybrid mismatch arrangements. It is an internationally consistent, proactive option which delivers net benefits to New Zealand greater than that of the other options considered.

Option 2 will improve the neutrality of New Zealand's tax system. Businesses that are able to exploit hybrid mismatch arrangements can currently operate at lower effective tax rates when compared with other businesses. This can result in a 'hybrid' business crowding out more productive investment and making international investment decisions based on whether a mismatch is available rather than commercial grounds. In addition, the imposition of higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrid mismatches is likely to be less efficient than imposing more moderate taxes across all economic actors. By eliminating the tax benefit of hybrid mismatch arrangements in a comprehensive way, these inefficiencies can be removed.

In a related sense, option 2 will help to improve the equity and fairness of the New Zealand tax system. Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally.

Option 2 will also have revenue collection benefits. The New Zealand tax revenue loss caused by the use of hybrid mismatch arrangements is difficult to estimate because the full extent of arrangements involving New Zealand is unknown and because the behavioural effects of introducing hybrid mismatch rules are difficult to ascertain. However, the tax revenue at stake is significant in the cases that Inland Revenue is aware of.

Importantly, the case for New Zealand to adopt the OECD recommendations is strengthened by the fact that other countries have enacted, or are proposing to enact, hybrid mismatch rules. This is because a hybrid mismatch arrangement involving a New Zealand counterparty may still be neutralised by the other country if they have a 'secondary' right to counteract under OECD principles. In that case, the tax benefit of the hybrid mismatch would be eliminated, but the tax collected would be by the counterparty country. In these circumstances, New Zealand would be better off having its own hybrid mismatch rules so that it can collect revenue when it has the priority to do so under the OECD recommendations. Whether New Zealand or the counterparty country collects any additional revenue as a result of implementing the rules depends on the actions taken by the affected business.

Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch

rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as "unstructured imported mismatches". This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

Accordingly, the compliance costs of the regulatory proposal are to be minimised to the extent possible, while still introducing a comprehensive set of rules to deal with the range of OECD-identified hybrid mismatches. This is where option 2 shows its advantage over option 1 which we view as having similar efficiency, fairness and revenue benefits. Option 1 would result in relatively higher compliance costs because the OECD recommendations are designed as a general set of best-practice rules and, in regards to their detail, are not necessarily optimal for individual countries such as New Zealand. When compared with option 1, option 2 ensures that the rules are workable and appropriate for the New Zealand tax environment.

It is also important to note that the ongoing compliance costs relating to this regulatory issue are expected to be optional in the majority of cases. The proposed rules will apply to taxpayers who use a hybrid mismatch arrangement after the rules become effective. Those taxpayers will generally have the option of incurring one-off costs to restructure into non-hybrid arrangements and remove themselves from the scope of the proposed rules.

Any higher tax payments resulting from the non-status quo options will make cross border investment less attractive for taxpayers using hybrid mismatch arrangements. However, these taxpayers should not be allowed to exploit hybrid mismatches to achieve a competitive advantage over taxpayers that do not use hybrid mismatch arrangements (such as purely domestic firms). Further, a significant number of New Zealand's major investment partners have introduced or will introduce hybrid mismatch rules. Other countries adopting these rules means that in many cases the tax efficiency of hybrid mismatch arrangements in New Zealand will be negated through the operation of the other country's rules on the counterparty, As a result, we believe that any impacts on inbound and outbound cross border investment from introducing hybrid mismatch rules in New Zealand will be low.

The status quo option would involve the least complexity and lowest compliance costs. However, similar to the cross-border investment discussion above, taxpayers whose groups deal with New Zealand's major trading partners that are adopting hybrid mismatch rules would have to understand the impact of those rules. The additional complexity of New Zealand having hybrid mismatch rules would therefore be lessened by the international momentum in this area.

Option 3 is an option that was preferred by many submitters to the Government discussion document on hybrid mismatch arrangements. Submitters pointed out that many of the structures considered by the OECD to be problematic have not been seen in New Zealand and therefore do not need to be counteracted. They also argued that the OECD recommendations are complex and have the potential for overreach. We do not think a targeted approach would serve New Zealand well when compared with option 2. The OECD recommendations are a coherent package intending to deal to the problem of hybrid mismatch arrangements exhaustively. Deliberately omitting aspects of the recommendations from New Zealand's response may cause taxpayers to exploit those remaining hybrid mismatch opportunities (which may even be seen as tacitly blessed). To the extent that happens, the efficiency, revenue, and fairness benefits of option 3 would be eroded. In

addition, other countries such as the United Kingdom and Australia have introduced or are intending to introduce a relatively comprehensive set of hybrid mismatch rules. If New Zealand does the same it will ensure our rules are internationally comparable and that they interact well with the rules of other countries without significant compliance issues. By favouring option 2, we also have consulted extensively on the OECD recommendations and how they should best be introduced into New Zealand law. This consultation has enabled us to design suitable modifications to the OECD recommendations to reduce complexity and compliance costs, limit overreach, and in some cases, increase the efficiency of the outcomes.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Increased costs from understanding the rules and applying them to taxpayers' transactions and structures. Or, restructuring costs of transitioning to non-hybrid arrangements to fall outside the scope of the rules.	Medium	Medium
	Tax payable: Foreign hybrid entity double deduction structures are included in the rules and we are confident of collecting a significant amount of revenue from the disallowance of that type of hybrid mismatch arrangement.	Approximately $50 million per year on an ongoing basis	Low*
Regulators	Administrative costs: Inland Revenue staff, particularly investigations staff, need to develop their knowledge of the hybrid mismatch rules.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised	Compliance costs	Medium	Medium

costs	Administrative costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Revenue collected from tax payable item described above.	Approximately $50 million per year on an ongoing basis	Low*
	Reduced administrative costs: Less investigations and disputes resources spent on hybrid mismatch arrangements using the general anti-avoidance law (GAAR).	Low	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised benefits	Reduced administrative costs	Low	High

*Note that the evidence for the $50 million figure is strong, but it is a conservative estimate made in light of the behavioural uncertainty associated with introducing hybrid mismatch rules together with the fact that the full extent of hybrid mismatch arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?

As discussed above, allowing the use of hybrid mismatch arrangements is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders as it is something that is fundamental to the tax system itself.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 2 (tailored adoption of OECD recommendations) conforms to the expectations for the design of regulatory systems document.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its Tax Information Bulletin (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018. The major exceptions are:

- the proposed rule for "unstructured imported mismatch arrangements", which we recommend be delayed until income years starting on or after 1 January 2020; and
- the proposed rules applying to New Zealand "reverse hybrids", which we recommend be delayed until income years starting on or after 1 April 2019.

Another exception we recommend is a grandparenting rule that exempts from application of the rules (until the next call date) hybrid financial instruments issued by banks as regulatory capital (in Australian or New Zealand) to third party investors before the discussion document release date of September 2016.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider an application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. Audit staff will need to familiarise themselves with the proposed rules and how they operate in practice. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their hybrid mismatch arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we are minimising compliance costs where possible under our tailored adoption of the OECD recommendations. For example, and as mentioned above, we have delayed the application date of the unstructured imported mismatch rule contained in the OECD recommendations to acknowledge that it would be significantly more difficult and costly to comply with than the other rules if it applied at the outset.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

However, it may be difficult to assess the true impact of this regulatory proposal. This is because many taxpayers using hybrid mismatch arrangements may rearrange their affairs to fall outside the scope of the proposed rules. It will be difficult to measure the full extent of this behavioural effect.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – strengthening our interest limitation rules

Proposal

1. This paper seeks Cabinet approval to strengthen New Zealand's rules that prevent excess interest deductions being taken in New Zealand. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, have large interest deductions leaving little taxable profit in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

3. We recommend that Cabinet agree in principle to two major reforms to our interest limitation rules:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the rules that set the debt levels allowed in New Zealand for taxpayers with international connections (the thin capitalisation rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

4. We also recommend several minor improvements to the rules to ensure they are robust and fit for purpose.

5. These changes follow the Government discussion document *BEPS – strengthening our interest limitation rules (March 2017).* In general, submitters on the discussion document acknowledged the need to respond to BEPS concerns but most did not agree with the specific proposals put forward.

6. Some of the proposals have been modified in response to these submissions. In particular, the approach for setting the allowable interest rate on related-party loans is different to that proposed in the discussion document. We anticipate that this new approach will address many, but not all, of submitters' concerns.

7. There are some technical elements to these reforms that could benefit from further discussion with stakeholders. We therefore request that authority be delegated to the Minister of Finance and the Minister of Revenue to finalise the reforms.

8. The forecast revenue from implementing these changes is $45m in 2018/19 and $90m per annum from 2019/20. Note, however, that one technical detail to be canvassed in the further discussion with stakeholders could reduce the forecast revenue by up to $10m per annum.

Background

9. The use of debt is one of the simplest BEPS strategies. Multinationals with excessive levels of debt, or with related-party debt with high interest rates, are able to take large interest deductions. This results in little taxable profit being left in New Zealand. Robust rules limiting the use of debt (and the interest rates of that debt) are important base protection measures.

10. Accordingly, in March this year the Government released the discussion document *BEPS – Strengthening our interest limitation rules*. There were two key proposals: one to strengthen how related-party debt is priced, and one tightening the rules governing allowable debt levels.

11. The discussion document also recommended several minor improvements to New Zealand's interest limitation rules to ensure they are robust and fit for purpose.

Comment

12. The majority of multinationals operating in New Zealand have relatively conservative debt positions, and the Government is committed to making sure New Zealand remains an attractive place for them to do business.

13. However, there are some multinationals that deliberately attempt to minimise their tax payments in New Zealand by engaging in BEPS strategies, such as by having related-party debt with excessive interest rates. These multinationals should not be allowed to exploit weaknesses in the current rules to achieve a competitive advantage over more compliant multinationals or domestic firms.

14. Accordingly, we recommend changes to New Zealand's interest limitation rules, most significantly:

- a *restricted transfer pricing rule* for setting the allowable interest rate on related-party loans from a non-resident to a New Zealand borrower; and
- tightening the thin capitalisation rules, which set the debt levels allowed in New Zealand for taxpayers either with foreign parents (the inbound rules) or foreign subsidiaries (the outbound rules) – in particular, setting the allowable debt level with reference to the taxpayer's assets net of its non-debt liabilities.

Restricted transfer pricing

15. When borrowing from a third party (such as a bank), commercial pressure will drive the borrower to obtain a low interest rate. The same pressure does not necessarily exist in a related-party context, such as when a New Zealand subsidiary borrows from its foreign parent. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates.

16. Broadly speaking, transfer pricing a loan agreement involves determining (hypothetically) the interest rate a third party lender would be willing to lend at, given the terms and conditions of the related-party loan. It is a fact specific and resource intensive exercise and can be manipulated (for example, by adding terms and conditions to the related-party loan that are not frequently seen between unrelated parties). We note that commentators such as Richard Vann, a professor of tax at the University of Sydney, have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

17. For these reasons, the international consensus is moving away from using ordinary transfer pricing as the primary mechanism to limit the interest rates on related-party debt. The OECD, for example, has recommended that countries adopt a simple formulaic approach for limiting interest deductions, which would largely eliminate the advantage of using related-party debt with excessive interest rates (this approach was raised in consultation but was not supported by submitters as it would make a taxpayer's allowable interest deductions volatile. Instead, as outlined below, we are recommending that the current rules for setting allowable debt levels be buttressed by rules that ensure related-party interest rates are appropriate).

18. Accordingly, we recommend that the allowable interest rate for inbound related-party loans be determined under a *restricted transfer pricing* methodology. Inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have substantial third party debt featuring those terms and conditions.

19. The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign parent.

20. This *restricted transfer pricing rule* would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate that is the same as the interest rate facing the borrower's foreign parent would automatically be considered acceptable. This safe harbour would be attractive to many companies as it is both simple and provides certainty.

21. We note that the Australian Taxation Office has recently released administrative guidelines which outline a similar approach for limiting related-party interest rates (albeit Australia is implementing this approach as an operational policy, rather than a law change).

Private sector consultation

22. This *restricted transfer pricing rule* is different to the proposal suggested in the March discussion document. The original proposal was a hard rule to cap the interest rate a foreign parent could charge its New Zealand subsidiary based on the foreign parent's credit rating (an "interest rate cap").

23. We consider that the *restricted transfer pricing rule* is a more workable way of achieving essentially the same objective – ensuring the interest rate on related-party debt is in line with what would actually be paid on third party debt. While the methods (restricted

transfer pricing and the interest rate cap) are different in approach, the outcome of both will generally be the same – with differences only at the margin. Accordingly, both approaches have the same revenue impact.

24. Submitters on the March discussion document did not support the original proposal. Many submitters argued that a new approach for pricing related-party debt is unnecessary, noting that the Government proposed to strengthen the transfer pricing rules generally (in the other March discussion document *BEPS – transfer pricing and permanent establishment avoidance*).

25. Some submissions highlighted the consequences of adopting a blunt rule in the nature of the cap. These include concerns that:

- the cap is not a good proxy for an arm's length interest rate in some situations and so could result in double taxation;
- the cap would deny deductions even when the amount of debt in the subsidiary was low;
- the cap may increase compliance costs, for example, where a foreign parent has no credit rating (about half of New Zealand's largest foreign-owned businesses are owned by companies with no credit rating); and
- the proposal involves different rules for firms owned by a group of non-residents rather than a single foreign parent, which creates perceptions of unfairness.

26. It should be noted that the *restricted transfer pricing rule* we are recommending will address many, but not all, of submitters' concerns because it is still a significant departure from using ordinary transfer pricing. Accordingly, we expect it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur with any frequency because of the shift in the international consensus on what is acceptable in relation to the pricing of related-party debt.

Allowable debt levels in the thin capitalisation rules

27. New Zealand has rules to prevent the excessive use of debt by foreign-owned entities operating in New Zealand (inbound investment) and New Zealand-owned entities with international operations (outbound investment). Interest deductions are denied to the extent that the entity's debt level with reference to its assets is determined to be excessive.

28. The March discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest bearing debts). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

29. The core objectives of the thin capitalisation rules are better served with the non-debt liability adjustment. Under the current rules, where non-debt liabilities are ignored, companies are able to have high levels of debt (and therefore high interest deductions) relative to the capital invested in the company. The current treatment of non-debt liabilities also mean the rules apply unevenly across companies: companies with the same level of profit or loss can have very different thin capitalisation outcomes, depending on their non-debt liabilities.

30. In addition, one of the objectives of the thin capitalisation rules (ensuring that a taxpayer is limited to a commercial level of debt) is undermined by the current treatment of non-debt liabilities. A third party lender, when assessing the credit worthiness of a borrower, would take into account its non-debt liabilities.

31. Australia requires this same adjustment for non-debt liabilities.

Private sector consultation

32. This proposal was accepted by some submitters but opposed by others who argued, for example, that the proposal amounts to a substantial reduction in the amount of deductible debt allowable under the thin capitalisation rules. Overall, this proposal was much less contentious than the interest rate cap.

33. None of the submissions against the core proposal convinced us that the analysis above, suggesting that the non-debt liability adjustment is appropriate, is incorrect. Accordingly, we recommend that the proposed adjustment to the allowable debt level under the thin capitalisation rule proceed. That is, a taxpayer's allowable debt level under the rules should be set with reference to their assets net of their non-debt liabilities.

34. A near-universal comment from submitters was that certain non-debt liabilities – most significantly *deferred tax liabilities* – should be carved out from the proposed non-debt liability adjustment. Deferred tax is an accounting concept. Accounting standards require that companies recognise deferred tax on their balance sheets in certain situations. In principle, a deferred tax liability is supposed to represent future tax payments that a taxpayer will be required to make. Submitters argued that this is often not the case – deferred tax liabilities are frequently technical accounting entries and do not reflect future tax obligations. Submitters also pointed to the rules in Australia, which do include a carve-out for deferred tax liabilities and assets.

35. We recommend further consultation on whether deferred tax should be carved-out from this non-debt liability adjustment. Many, but not all, deferred tax liabilities represent a genuine requirement that tax on current accounting profits will be payable in the future. Given the concerns raised by submitters, further consultation on this technical detail would be beneficial.

Other changes

36. We recommend five other changes to the thin capitalisation rules:

- a special rule for infrastructure projects (such as public private partnerships) that are controlled by a single non-resident;
- a de minimis for the inbound thin capitalisation rules;
- reducing the ability for companies owned by a group of non-residents to use related-party debt;

- removing the ability to use asset valuations for the thin capitalisation rules that differ from those reported in a firm's financial accounts; and

- removing the ability to measure assets and debts on the final day of a firm's income year.

37. These measures were all discussed in the March discussion document. Some were supported by submitters, while others were opposed. Where they were opposed, we are recommending changes to the proposals which will, in general, address submitters' concerns.

Rule for infrastructure projects

38. We recommend a special rule that allows all of a taxpayer's third party debt to be deductible even if the debt levels exceed the normal thin capitalisation limits, provided the debt is non-recourse with interest funded solely from project income.

39. This will allow a wider group of investors to participate in public-private partnerships without interest expense denial than has been possible previously.

40. This rule was well received by submitters; however, some technical issues have been raised which we will consult further on.

De minimis for the inbound rules

41. The thin capitalisation rules that apply to New Zealand-owned taxpayers with foreign operations (the outbound rules) has a de minimis (the rules do not apply if a taxpayer has interest deductions of less than $1 million). The thin capitalisation rules that apply to foreign-owned taxpayers (the inbound rules) do not have a similar de minimis.

42. We recommend the current de minimis in the outbound rules be extended to taxpayers subject to the inbound rules, provided the taxpayer has only third party debt. This proposal is to reduce compliance costs for small foreign-owned entities that have a low risk of BEPS.

43. This proposal was generally supported by submitters.

Allowable debt levels for companies owned by a group of non-residents

44. At present, when an entity is controlled by a group of non-residents acting together, its allowable debt level is the greater of:

- 60 percent; and

- 110 percent of its third party debt.

45. However, this means that a taxpayer with high levels of third party debt can be funded with almost no equity. For example, a project funded 90 percent with third party debt could have 9 percent shareholder debt and only 1 percent equity.

46. To address this, we recommend changing this test so that, if an entity has a debt level in excess of 60 percent, the interest deductions on its related-party debt should be denied to the extent the entity's debt level exceeded 60 percent. This proposal was generally accepted by submitters.

47. The March discussion document proposed that this change be grandparented, as the rules it relates to (for non-residents acting together) have only just taken effect. We recommend that the precise design of this grandparenting be subject to further consultation with stakeholders, with decisions on its final design being delegated to the Ministers of Finance and Revenue.

Asset valuations

48. In general, the thin capitalisation rules are based on the value of a company's assets as reported in its financial statements. However, a company may use the net current value of an asset as an alternative to its financial statement value, provided that would be allowable under generally accepted accounting principles.

49. While it is permissible to use an asset's net current value, the thin capitalisation rules set out what is required if taxpayers utilise this option. Accordingly, we recommend that this new net current valuation option be available only if certain criteria are met – such as if the valuation is from an independent expert valuer.

Agency consultation

50. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, and publicity

51. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

52. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

53. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

54. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – strengthening our interest limitation rules* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing their overall effectiveness.

3. **Agree** that the interest rate on inbound related-party loans should be set using a *restricted transfer pricing* rule, whereby the interest rate is set under transfer pricing but ignoring all surrounding circumstances, terms, and conditions that could result in an excessive interest rate unless similar terms apply to significant amounts of third party debt, and with the rebuttable presumption that the borrower would be supported by its foreign parent.

4. **Agree** that a taxpayer's allowable debt level in the thin capitalisation rules should be set with reference to its assets less its non-debt liabilities.

5. **Agree** that the de minimis in the outbound thin capitalisation rules, which provides an exemption from the rules for groups with interest deductions of $1 million or less, be made available also to foreign-controlled taxpayers provided they have no owner-linked debt.

6. **Agree** that an exemption should be provided from the thin capitalisation rules for certain infrastructure projects funded entirely with third party limited recourse loans.

7. **Agree** that, when an entity is controlled by a group of non-residents acting together, interest deductions on any related-party debt should be denied to the extent the entity's debt level exceeds 60 percent.

8. **Agree** that clear legislative requirements be developed for when taxpayers choose to value their assets for thin capitalisation purposes on a basis other than that used in their financial accounts.

9. **Agree** that an anti-avoidance rule should be inserted into the thin capitalisation rules, to apply when a taxpayer substantially repays a loan just before the end of the year.

10. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

11. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

12. **Authorise** the Minister of Finance and the Minister of Revenue jointly to take final decisions on the extent to which deferred tax liabilities are included in non-debt liabilities, up to a limit of reducing the level of expected revenue increases

anticipated by the BEPS measures as set out in recommendation 7 in the accompanying Cabinet paper *Tax Measures To Prevent Base Erosion And Profit Shifting* by up to $10 million per annum

13. **Agree** that the results of the decisions in recommendations 3-12 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – strengthening our interest limitation rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*The analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The problem the proposals discussed in this impact statement seek to address is the use of debt financing by taxpayers to reduce their New Zealand income tax liability significantly.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The adoption of a restricted transfer pricing rule for determining the allowable interest rate (for tax purposes) on related-party loans from a non-resident to a New Zealand borrower will help ensure interest rates on such loans cannot be excessive. In addition, changing the way deductible debt levels are calculated under the thin capitalisation rules will ensure that taxpayers with little equity are unable to have large amounts of deductible debt. These changes will provide a solution that is sustainable, efficient and equitable, while minimising impacts on compliance and administration costs.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that the new interest limitation rules are forecast to produce approximately $80–90 million per year on an ongoing basis. There are also efficiency and fairness benefits to these proposals which cannot be assigned to particular beneficiaries.

Where do the costs fall?
The costs primarily fall on foreign-owned taxpayers operating in New Zealand (though there may be some minor impacts on New Zealand-owned taxpayers with international operations). Tax payments for affected parties are forecast to increase by approximately $80–90 million per year on an ongoing basis.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
As with all tax rules, there is some risk of taxpayer non-compliance. However, this is mitigated as the rules predominately apply to large companies – and the tax affairs of large companies are closely monitored by Inland Revenue.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is moderate evidence in relation to the problem of excessive interest rates on related-party debt, and good evidence in relation to allowable debt levels. Inland Revenue has some data on interest rates paid on related-party debts, as well as examples of structures that appear to have the effect of increasing the interest rate on such debt. However, this data is not comprehensive. Inland Revenue has data on the debt, asset and equity levels of significant foreign-owned enterprises, which allows an accurate estimation of the impact of the non-debt liability adjustment for those firms.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *BEPS – strengthening our interest limitation rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the Quality Assurance criteria.

Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – strengthening our interest limitation rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy changes to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem While good evidence of base erosion and profit shifting (BEPS) is generally difficult to come by, there is an exception for BEPS in relation to interest payments. Fairly good data on interest deductions (especially for large firms) is available for analysis through Inland Revenue's International Questionnaire. This dataset includes debt levels, related-party debt levels, and related-party interest payments of large foreign-owned firms. However, there are still limitations to that data – for example, data on interest rates on related-party debt (and the interest rates facing a New Zealand subsidiary's parent company) is not captured in the Questionnaire. Where possible, this information was obtained from other sources (such as credit ratings of parent companies and disclosed related-party interest rates in financial statements) or estimated (for example, estimating interest rates based on related-party interest payments and related-party debt amounts). However, this other data is less comprehensive and accurate. **Consultation** The preferred option in relation to limiting interest rates on related-party interest rates has not been subject to consultation. This was because it was developed in response to submissions on the original proposals. However, it is similar in many respects to the original proposal, which was subject to consultation. In addition, to ensure the rule operates effectively and to mitigate the risk of unintended outcomes, it will be subject to consultation with submitters on the technical detail.

Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to tax planning strategies used by some multinational enterprises (MNEs) to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over MNEs not engaged in BEPS and domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter BEPS.

BEPS using interest deductions

The use of debt financing is one of the simplest ways of shifting taxable profits from one jurisdiction to another. For example, because interest payments are deductible, a related-party cross-border loan from a parent to a subsidiary can be used to reduce taxes payable in the jurisdiction that the subsidiary is located.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations. This includes developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4).

If no further action is taken, MNEs that currently have high levels of debt in New Zealand, or highly-priced related-party debt, will be able to continue paying little tax in New Zealand. There is also a risk that additional MNEs would adopt similar structures.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

New Zealand's tax system has been the subject of numerous broad-based reviews – most recently the Victoria University of Wellington Tax Working Group in 2010. It is well regarded and generally functions well.

No other government agencies have a direct interest in the tax system. However, a good tax system is important for a well-functioning economy – many government agencies therefore

have an indirect interest in the tax system.

Foreign investment in New Zealand is generally taxed under our company tax at 28 percent. New Zealand's tax system has rules that limit the deductible debt levels and interest rates for taxpayers with foreign connections. These rules affect only foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Thin capitalisation rules

New Zealand has "thin capitalisation" rules to limit tax deductions for interests that non-residents are allowed. These rules generally require an investment owned by a non-resident to have a debt-to-asset ratio of no more than 60 percent (interest deductions are denied to the extent the allowable debt-to-asset ratio is exceeded).

Thin capitalisation rules also apply to New Zealand-owned firms (frequently referred to as the "outbound thin capitalisation rules"). These rules generally require a debt-to-asset ratio of no more than 75 percent. They are designed to prevent a disproportionate portion of a New Zealand company's debt being placed in New Zealand.

Like the tax system as a whole, we consider that the thin capitalisation rules are serving us well. The rules are well understood and taxpayers subject to the rules generally have conservative debt levels and, for those with related-party debt, the debt is at conservative interest rates – as evidenced by the significant amount of tax paid by foreign-owned firms operating in New Zealand (foreign controlled firms paid 39 percent of company tax in the 2015 tax year).

Transfer pricing rules

It is important to limit not just the quantum of debt in New Zealand, but also the interest rate on that debt. For third-party debt, commercial pressures will drive the borrower to obtain as low an interest rate as possible. However, these pressures do not necessarily exist in a related-party context. A rule to constrain the interest rate of such debt is necessary. Transfer pricing rules provide the current constraint on interest rates. Broadly speaking (and as they apply to related-party debt), these rules seek to ensure that the interest rate on a given loan contract is in line with what would have been agreed between unrelated parties.

NRWT

While payments of interest to related parties are deductible, they are subject to non-resident withholding tax (NRWT). NRWT applies at either 15 percent or 10 percent, depending on whether New Zealand has a Double Taxation Treaty with the interest recipient's home jurisdiction. This means that, while the use of debt can reduce tax payable in New Zealand, it does not completely eliminate it.

2.3 What is the policy problem or opportunity?

A simple way that non-residents can reduce their New Zealand tax liability significantly is by capitalising a New Zealand investment with debt instead of equity, because they can then take interest deductions in New Zealand. This is shown in the example below.

> ***Example***
> *Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.*
>
> *Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.*

Having a generally well regarded tax system does not mean that tax changes are unnecessary. An on-going policy challenge is to ensure that our tax rules are up to date and ensure that MNEs are paying a fair amount of tax in New Zealand. Base protection measures – such as rules for limiting the amount of debt allowable in New Zealand, and the interest rate on that debt – are therefore important.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

This impact statement considers two related policy opportunities:

- ensuring the rules for setting the allowable interest rates on related-party debt are sufficiently robust; and
- ensuring the basis for setting the allowable debt level in the thin capitalisation rules is appropriate.

Scale of the problem

The OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan) included developing best-practice rules to limit BEPS using interest deductions (BEPS Action 4). We consider the fact that the OECD has included profit shifting using interest in its BEPS Action Plan as evidence that this is a significant policy issue internationally.

As mentioned above, most MNEs operating here have relatively low levels of debt and do not have interest rates considered to be excessive. However, there are a small number of taxpayers with either debt levels that are too high, or interest rates that are excessive. While small in number, the fiscal impact of these arrangements is significant – we estimate the tax revenue lost is $80–90 million per year.

2.4 Are there any constraints on the scope for decision making?

There are no constraints on scope.

2.5 What do stakeholders think?

Stakeholders

The stakeholders are primarily taxpayers (in particular, MNEs) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules.

Consultation already undertaken

In March 2017, the Government released the discussion document *BEPS – strengthening our interest limitation rules*. The discussion document consulted on two key proposals which are considered in this impact statement – new interest limitation rules and a non-debt liabilities adjustment to the thin capitalisation rules.

The Government received 27 submissions on the discussion document. Most submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

In general, submitters acknowledged the need to respond to BEPS risks facing New Zealand, and that part of this would involve strengthening New Zealand's rules for limiting interest deductions for firms with cross-border related-party debt. However, many submitters did not support the specific proposals put forward.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Interest limitation

The discussion document proposed moving away from a transfer pricing approach for pricing inbound related-party loans. Instead, the allowable interest rate for such a loan would – in most instances – be set with reference to the New Zealand borrower's parent's borrowing costs (referred to as an "interest rate cap").

General reaction

Most submitters argued that the interest rate cap proposal was not necessary and should not proceed. They noted that the Government, in the discussion document *BEPS – transfer pricing and permanent establishment avoidance*, proposed to strengthen the transfer pricing rules generally. Submitters wrote that these strengthened rules should be sufficient to address any concerns about interest rates.

Submitters expressed concern about the proposed interest rate cap for a number of reasons, including that it:

- is inconsistent with the arm's length standard, so would result in double taxation;
- will increase compliance costs;
- will apply to firms with a low BEPS risk; and
- has no international precedent.

Only two submitters wrote in favour of the proposed cap. However, the proposal did attract positive comments from knowledgeable parties that did not put in a formal submission. Michael Littlewood, a professor of tax at Auckland University, has said that the Government is right to seek to limit interest rates on related-party debts.

Richard Vann, a professor of tax at the University of Sydney, has made similar remarks – "transfer pricing has not proved up to the task of dealing with interest rates, so it is necessary to come up with clearer and simpler rules".

Allowable debt levels

The thin capitalisation rules limit the amount of debt a taxpayer can claim interest deductions on in New Zealand ("deductible debt"). Currently, the maximum amount of deductible debt is set with reference to the value of the taxpayer's assets (generally, debt up to 60 percent of the taxpayer's assets is allowable).

The discussion document proposed changing this, so that a taxpayer's maximum debt level is set with reference to the taxpayer's assets net of its non-debt liabilities (that is, its liabilities other than its interest-bearing debts (a "non-debt liability adjustment"). Some common examples of non-debt liabilities are accounts payable, reserves and provisions, and deferred tax liabilities.

General reaction

Several submitters indicated they supported the proposal in principle and understood the need for this change, raising only technical design issues (particularly relating to deferred tax).

A number of other submitters argued that the proposal should not go ahead. They submitted that the proposed change would introduce volatility to taxpayers' thin capitalisation calculations and is not relevant to BEPS. They also wrote that the proposed exclusion of non-debt liabilities from assets would amount to a material reduction in the existing 60 percent safe harbour threshold.

Stakeholders' views displayed no clear pattern. Two big accounting firms agreed with the proposal while two others disagreed. Similarly, of the three major stakeholder groups who submitted on the proposal, one supported and two opposed the change.

Deferred tax

To remove the mismatch between income tax calculated on taxable profits and income tax calculated on profits recognised for accounting purposes, deferred tax balances are recognised in financial statements. As such, a taxpayer's non-debt liabilities could include "deferred tax liabilities", which arise when accounting profits are greater than profits for tax purposes. Similarly, a taxpayer's assets could include "deferred tax assets" which arise when profit for tax purposes is greater than accounting profit.

All submitters that commented on this proposal were of the view that, for the purposes of the non-debt liability adjustment, deferred tax liabilities should be ignored. Submitters also wrote that deferred tax assets should be excluded from assets. That is, a taxpayer's assets for thin capitalisation purposes would be: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Submitters noted that Australia's thin capitalisation rules feature this adjustment for deferred tax. They argued that our rules should feature a similar adjustment because:

- often deferred tax does not represent a real cash liability the company has to pay in the future;
- deferred tax balances are ignored when third-parties (including third-party lenders) are assessing the financial position of an entity; and
- deferred tax balances can be volatile – taxpayer thin capitalisation levels could become volatile without excluding them.

Further consultation

Following Cabinet decisions in July 2017, officials are planning to undertake further public consultation on outstanding policy issues, technical design details and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Related-party interest rates

We have identified five mutually exclusive options to the address the problem of excessive interest rates on related-party debts.

Option 4 (administrative guidance) is a non-regulatory option. The other options for change involve changing New Zealand's tax legislation.

Option 1: Interest rate cap (discussion document proposal)

As described in section 2.5.

Option 2: Restricted transfer pricing

Under a restricted transfer pricing approach, inbound related-party loans would be priced following the standard transfer pricing methodology. However, it would contain two additional elements to clarify that:

- There is a rebuttable presumption that the New Zealand subsidiary would be supported by its foreign parent; and
- All circumstances, terms, and conditions that could result in an excessive interest rate will be required to be ignored – unless the taxpayer can demonstrate that they have third-party debt featuring those terms and conditions. The types of modifications to the terms, conditions and surrounding circumstances we would seek to make under this approach are:
  - That the loan has no exotic terms that are generally not seen with third-party lending
  - That the loan is not subordinated
  - That the loan duration is not excessive
  - That the debt level of the borrower is not excessive.

The combined effect of these additional elements is that the interest rate on related-party debt will generally be in line with the interest rate facing the New Zealand borrower's foreign

parent.

This restricted transfer pricing rule would be coupled with a safe harbour, which would be based on the interest rate cap as initially proposed. This could be provided administratively. A related-party loan with an interest rate consistent with the interest rate cap would automatically be considered acceptable.

This option was developed following consultation to address some of the concerns raised by submitters; however, it has not itself been subject to consultation.

Option 3: Adopt EBITDA-based rule (OECD recommended approach)

This option would involve limiting the amount of interest deductions a taxpayer is allowed with reference to their earnings (specifically, their profits before deductions for interest, depreciation and amortisation are taken into account, also known as their EBITDA). This new approach would completely replace the thin capitalisation rules, becoming the new method for limiting interest deductions for taxpayers with international connections.

This approach would constrain the tax effectiveness of highly priced debt, since it directly limits interest deductions rather than limiting the amount of debt; a taxpayer with highly priced debt would be more likely to exceed their EBITDA limit and face interest denial.

Almost all submitters did not support the adoption of an EBITDA-based rule.

Option 4: Administrative guidance

This option would involve Inland Revenue issuing administrative guidance on how it will assess the risk of related-party lending transactions – similar to what has recently been released by the Australian Taxation Office (ATO) (discussed below).

Under this option, related-party loans with certain features (such as having an interest rate in line with the interest rate facing the borrower's foreign parent) would be given a low risk rating and be unlikely to be challenged by Inland Revenue. Taxpayers with higher interest rates would be more likely to have their related-party loan investigated.

Several submitters suggested this option be adopted in place of the interest rate cap. They argued that it would provide certainty for taxpayers who desired it, but taxpayers who value certainty less would be free to breach the guidelines.

Option 5: Status quo (ordinary transfer pricing)

This option would involve continuing to price related-party debt under the transfer pricing rules. As discussed above, the Government proposed strengthening these rules in the discussion document *BEPS – transfer pricing and permanent establishment avoidance.* Many submitters argued that this should be sufficient to address any concerns over related-party interest rates.

Relevant experience from other countries

The ATO has released draft guidelines regarding the interest rates of cross-border related-party loans.[1] These guidelines are designed to encourage Australian subsidiaries of multinational companies to restructure their related-party loans into ordinary "vanilla" loans. Overall, the guidelines have a clear expectation that the interest rate on related-party loans should be in line with the foreign parent's cost of funds:

> "Generally, the ATO expects any pricing of a related-party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong."

Allowable debt levels

We have identified three mutually exclusive options relating to setting the allowable debt level under the thin capitalisation rules.

The options (other than the status quo) involve changing New Zealand's tax legislation.

Option 1: Proceed with non-debt liabilities adjustment (as proposed in the discussion document)

As described in section 2.5.

Option 2: Proceed with non-debt liabilities proposal excluding deferred tax

Under this option, a taxpayer's deferred tax would be ignored for the purposes of the non-debt liability adjustment. That is, a taxpayer's allowable debt level would be set with reference to the result of the formula: (assets – deferred tax assets) – (non-debt liabilities – deferred tax liabilities).

Of submitters who supported the proposed non-debt liability adjustment in principle, this was the preferred option.

Option 3: Status quo (do not proceed with non-debt liabilities adjustment)

Under this option, maximum deductible debt levels would continue to be calculated under the thin capitalisation rules with reference to assets, ignoring non-debt liabilities.

As mentioned in section 2.5, this was the preferred option of some submitters.

Relevant experience from other countries

Australia has thin capitalisation rules that are broadly similar to New Zealand's. Australia's rules currently require a non-debt liability adjustment, but deferred tax is carved-out. That is, Australia's rules are consistent with option 2.

[1] ATO compliance approach to taxation issues associated with cross-border related-party financing arrangements and related transactions, PCG 2017/D4.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?
The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria: • *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible; • *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way; • *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible; • *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible; and • *Sustainability* – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved Efficiency, fairness and sustainability are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these three criteria.

3.3 What other options have been ruled out of scope, or not considered, and why?
No options were ruled out of scope.

Section 4: Impact Analysis

	Option 1 (interest rate cap)	Option 2 (restricted transfer pricing)	Option 3 (EBITDA-based rule)	Option 4 (administrative guidance)	Status quo
Efficiency and neutrality	+ Option 1 will provide a strong limit on related-party interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains. However, for some firms the interest rate allowed under the cap may be too low, which lowers the efficiency benefits.	++ Option 2 will provide a reasonably strong limit on related-party debt interest rates, reducing the ability for some firms to profit shift. This would level the playing field for firms, providing efficiency gains.	**0** Option 3 will provide an effective limit on all interest expenses (including related-party interest expenses). However, it also increases the uncertainty of returns on New Zealand investment, since whether or not interest is deductible turns on a taxpayer's EBITDA, which can be very variable.	+ Some taxpayers would benefit from the certainty provided by the administrative safe harbour. However, for taxpayers willing to exceed the safe harbour, this option is no different than the status quo – excessive interest rates on related-party debt would still be possible.	**0**
Fairness and equity	++ Option 1 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	++ Option 2 has fairness benefits as it would ensure taxpayers cannot have excessive interest rates on their related-party debts.	**0** On the one hand, option 3 would be somewhat effective at preventing excessive interest rates. On the other hand, it could result in interest denial for firms with very conservative interest rates and debt positions (say, for example, if a taxpayer is in loss).	**0** Option 4 would not prevent firms from achieving excessive interest rates on related-party debt. For taxpayers willing to exceed the administrative safe, harbour this option is no different to the status quo.	**0**
Efficiency of compliance	++ Option 1 would reduce compliance costs for many taxpayers – the allowable interest rate on related-party debt would be set on a clear objective factor (the credit rating of the foreign parent). However, in some cases – where the non-resident parent has no credit rating – compliance costs will stay the same or could potentially increase.	+ Option 2 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo)	**0** Compliance costs in some instances would reduce under option 3, as there would be fewer transfer pricing disputes about related-party debt. However, an EBITDA-based rule would be a fundamental shift in our interest limitation rules – taxpayers and agents would have to come to grips with an entirely new regime.	+ Option 4 would reduce compliance costs somewhat, as the interest rate cap would be available as a safe harbour. Taxpayers not utilising the safe harbour will still be required to do a transfer pricing analysis (i.e. same as status quo).	**0**

Efficiency of administration	++ Option 1 would avoid the need for potentially complex and expensive disputes over whether the interest rate on related-party debt is set appropriate.	++ Option 2 would reduce the need to review the interest rates of taxpayers utilising the safe harbour. For the remaining taxpayers, the restrictions (e.g. striking out exotic terms) would simplify the transfer pricing analysis.	+ Option 3 would reduce administration costs because there would be less need to review and challenge related-party loans under transfer pricing.	+ Option 4 would reduce the need to review the interest rates of taxpayers utilising the safe harbour.	**0**
Sustainability	+ Option 1 would apply to taxpayers that have structured their affairs to strip the maximum profits out of New Zealand; however, it could also affect the interest rates of less aggressive taxpayers.	++ Option 2 should generally only affect taxpayers with more aggressive debt structures.	**0** Option 3 could result in interest deduction denial even if a taxpayer has conservative debt levels.	+ Option 4 would not prevent firms from achieving excessive interest rates on related-party debt.	**0**
Overall assessment	+	++ **Recommended option**	**0**	+	**0**

Key:

++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Allowable debt levels

	Option 1 (non-debt liability adjustment)	Option 2 (adjustment with no deferred tax)	Status quo
Efficiency and neutrality	+ Option 1 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, submitters have argued that in some instances deferred tax (a type of non-debt liability) does not represent real liabilities; to the extent this is correct, reducing allowable debt levels in relation to these liabilities could hamper efficiency.	+ Option 2 will reduce the allowable debt levels for taxpayers with little equity (and high levels of non-debt liabilities). This will help ensure taxpayers have a more commercial level of debt. It will also equalise the thin capitalisation outcomes for taxpayers in otherwise similar situations. This should improve efficiency. However, this option carves out all types of deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option would allow some taxpayers to have too high a debt level.	**0**
Fairness and equity	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, submitters have argued that in some instances deferred tax does not represent a real liability. To the extent this is correct, including deferred tax in the non-debt liability adjustment could be seen as unfair.	+ Taxpayers with the same level of accounting profit will have the same thin capitalisation outcomes. This option therefore improves fairness. However, this option excludes all deferred tax – yet, in many instances, deferred tax will represent a future tax payment a taxpayer will be required to make. To the extent this is the case, this option will not treat taxpayers in the same situation the same.	**0**
Efficiency of compliance	**0** Neither option will have a significant impact on compliance costs. The result of both options is just a change to how the existing thin capitalisation calculations are carried out. However, there may be some one-off compliance costs if the changes mean taxpayers breach their thin capitalisation limits and, as a result, decide to restructure their borrowing.		**0**
Efficiency of administration	**0** Neither option has a significant impact on administrative costs. Thin capitalisation calculations are carried out by taxpayers – this change has no substantive impact on Inland Revenue.		**0**
Sustainability	+ Both options similarly target firms with debt levels that are too high relative to their levels of equity and are therefore well targeted. Firms with low levels of debt, or with reasonable levels of debt relative to equity, will be largely unaffected by either option.		**0**
Overall assessment	+	+	**0**

Key: ++ much better than the status quo + better than the status quo **0** about the same as the status quo - worse than the status quo - - much worse than the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Interest limitation

We consider that option 2 – developing a restricted transfer pricing approach – is the best option to limit interest expenses in relation to inbound related-party debt.

Following consultation and further analysis, we consider that if the Government pursued the interest rate cap (option 1), adjustments would be needed to the original discussion document proposal which would make it more complex. For example, to address some of the concerns expressed by submitters, a different or modified rule may need to be applied to firms with low levels of debt. The result of these adjustments would be that different rules would apply to taxpayers in different situations (more so than originally proposed). Such differences create perceptions of unfairness, and give rise to boundaries that can be difficult to formulate, administer and comply with. At the margins they may give rise to behaviours that are inefficient – especially as taxpayers try to arrange their circumstances to fall within certain boundaries.

The difficulty is, however, that simply relying on transfer pricing, as suggested by some submitters, will not achieve the desired policy outcomes. It is clear that the international consensus (as reflected in the OECD recommendation for countries to adopt an arbitrary formulaic approach (EBITDA)) is to move away from using ordinary transfer pricing to limit the interest rates on related-party debt. In addition, as noted in section 2.5, commentators have said that ordinary transfer pricing is unsuited to pricing related-party financing transactions.

Accordingly, we consider that the restricted transfer pricing rule is the best approach. Like the interest rate cap, it will ensure the policy objective – ensuring there is a robust mechanism for determining the interest rates for inbound related-party debt; however, since the restricted transfer pricing rule has more flexibility (compared to the interest rate cap – the other option that would most effectively achieve the policy objective) it is both more efficient and fairer.

Owing to the time available (and since it was developed subsequent to the initial consultation), this option has not been subject to consultation with stakeholders. This modification will address many, but not all of, submitters' concerns – it is still a departure from using ordinary transfer pricing. Nevertheless, we expect that it will be more acceptable compared to the originally proposed interest rate cap because:

- it allows for some limited flexibility – meaning the allowable interest rate can depart from the cost of funds facing the foreign parent if that is appropriate in the circumstances; and
- it would be subject to the Mutual Agreement Procedure under New Zealand's Double Tax Agreements, meaning taxpayers who consider that the new rule is inconsistent with the relevant treaty could seek resolution. This will address double taxation concerns. We do not, however, expect this will occur frequently because of the shift in the international consensus on what is acceptable in relation to the pricing of related party debt.

Allowable debt levels

At this stage, we do not have a preference between option 1 (non-debt liability adjustment as originally proposed) and option 2 (non-debt liability adjustment with deferred tax carve-out). Option 3 (status quo) is not preferred.

Both options 1 and 2 have similar impacts in terms of efficiency and fairness (and have no significant impacts in terms of compliance and administration costs). The non-debt liability adjustment in option 1 is potentially too extensive because of the inclusion of *all* types of deferred tax, but, on the other hand, the adjustment in option 2 is too narrow because of the exclusion of all deferred tax.

We consider that the best approach is to recommend neither options 1 or 2 at this stage, but instead consult further with stakeholders on whether there is another feasible option (since this is a minor technical detail, more consultation on this matter is feasible). For example, it might be possible to identify deferred tax liabilities that are the least likely to result in a future tax payment, and restrict the carve-out of deferred tax to just that identified group.

5.2 Summary table of costs and benefits of the preferred approach

Related-party interest rates

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40m per year	Medium
Regulators	Administration costs: There will be a one-off cost to Inland Revenue in developing guidance on how the new rules will operate.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40m per year	Medium
Non-monetised costs	Administration costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Reduction in compliance costs for firms that utilise safe harbour.	Medium	High
Regulators	Revenue: Tax collected will increase. Administration costs: Reduction in costs for ensuring related-party interest rates are appropriate.	Approximately $40m per year Medium	Medium High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40m per year	Medium
Non-monetised benefits	Compliance and administration cost reduction	Medium	High

Allowable debt levels

While a preferred option is not recommended, the costs and benefits of any option that is selected will be similar

Affected parties *(identify)*	**Comment***: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	Tax payable: It will result in additional tax paid.	Approximately $40–50m per year (depending on option)	High
Regulators			
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $40–50m per year	High
Non-monetised costs			

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Tax collected will increase.	Approximately $40–50m per year (depending on option)	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $40–50m per year	High
Non-monetised benefits			

5.3 What other impacts is this approach likely to have?

As discussed above, allowing BEPS through interest deductions is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take use interest deductions to reduce their New Zealand (and possibly worldwide) tax liability is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders. It is something that is fundamental to the tax system itself, which all of the stakeholders already discussed have an interest in preserving.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Implementation of both reforms (relating to related-party interest rates and allowable debt level) will be given effect through a combination of legislation and Inland Revenue administrative guidance. The legislative changes proposed will be progressed (subject to Cabinet approval) as part of a BEPS taxation bill to be introduced in late 2017. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin*.

In relation to the allowable debt level proposal, we will consult further with stakeholders on whether a preferred option can be identified. The Minister of Finance and Minister of Revenue will make the final decision on which option should be progressed (option 1, option 2, or a potential new option) following this consultation.

These reforms are expected to apply from income years beginning on or after 1 July 2018, subject to legislation progressing to enactment before this date.

Some submitters on the discussion document argued that transitional relief or grandparenting should be provided to give taxpayers sufficient lead-in time to restructure their affairs if necessary. We consider that the planned application date of 1 July 2018 is sufficiently prospective because:

- the interest rate proposal applies only to related-party transactions (which are more easily altered compared to transactions with third-parties); and
- in relation to the allowable debt level proposal, debt and asset levels under the thin capitalisation rules can be measured as at the end of the relevant income year, meaning taxpayers would have until at least 30 June 2019 to rearrange their affairs.

In addition, in response to consultation, we propose that advanced pricing agreements

(APAs) existing prior to the application date of these changes will be grandparented.

Once the proposals are implemented, Inland Revenue will be responsible for the ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

6.2 What are the implementation risks?

There is the risk that the relevant transfer pricing legislation could contain unintended errors or have unintended consequences. However, this risk can be efficiently managed by way of remedial amendments.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal. Inland Revenue closely monitors the tax affairs of New Zealand's largest companies (which are, in general, the affected population of these proposals). For example, Inland Revenue currently collects data from these firms on their debt levels (including levels of related-party debt) through its International Questionnaire. This will allow how the proposals have impacted debt levels and related-party interest payments to be analysed.

More generally, Inland Revenue is considering the appropriate level of information that should be collected to support the proposed rules for all the BEPS measures being implemented. Any additional information may be collected via a disclosure statement that must be provided to Inland Revenue or it may be collected using existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTTP involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, following enactment, any changes identified as necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – transfer pricing and permanent establishment avoidance

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to prevent permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue investigate uncooperative multinationals. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Some large multinationals are currently using tax arrangements which allow them to report low taxable profits in New Zealand despite carrying on significant economic activity here.

3. In March this year, the Government released a discussion document called *BEPS – Transfer pricing and permanent establishment avoidance* to consult on proposals to combat these arrangements. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan).

4. Submissions and workshops with the private sector were used to refine the proposals and better target them at the BEPS activities we are concerned about, whilst reducing the compliance costs and other unintended impacts on taxpayers engaging in ordinary, commercial dealings.

5. We recommend that nearly all of the proposals in the discussion document proceed, subject to some changes following consultation. The most significant changes made to the original proposals as a result of consultation were:

- The proposed permanent establishment (PE) avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

- Clarification of the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

- The proposal to require disputed tax to be paid earlier should not proceed. This is because we consider it to be unnecessary in light of the current "use of money" interest rate regime.

6. These changes are likely to be welcomed by submitters and do not reduce the overall effectiveness of the proposed reforms.

7. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

8. The forecast tax revenue from implementing the transfer pricing and PE avoidance measures is $25m in 2018/19 and $50m per annum from 2019/20. Some of this revenue has already been included in the Budget 2017 forecasts.

Background

9. In February this year, Cabinet agreed to release the Government discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (CAB-17-MIN-0041 refers).

10. The discussion document, which was released in March 2017, consulted on proposals to combat aggressive tax strategies which allow some multinationals to report low taxable profits in New Zealand despite carrying on significant economic activity here. These strategies involve:

- ***Tax structuring***: In order for New Zealand to tax a non-resident on its sales here, the non-resident must have a taxable presence (a permanent establishment or "PE") in New Zealand. However, non-residents can structure their affairs to avoid such a taxable presence, even when they are involved in significant economic activity here (PE avoidance). Non-residents can also enter into arrangements with related parties that reduce their taxable profits in New Zealand, but lack economic substance (transfer pricing avoidance).

- ***Creating enforcement barriers:*** It is difficult and resource intensive to assess and engage in disputes with multinationals in practice. This is due to the highly factual nature of the issues and the difficulties Inland Revenue faces in obtaining the relevant information.

11. The OECD and the G20 are also concerned about these kinds of BEPS strategies, and have recommended measures to address them in their 15 point BEPS Action Plan. These include:

- a widened definition of "permanent establishment" for double tax agreements (DTAs), to counter PE avoidance (however this will only be included in a DTA if both countries agree); and

- updated transfer pricing guidelines, to counter profit shifting.

Comment

12. We have developed a package of proposed tax law changes to combat transfer pricing and PE avoidance. The main elements of the proposed reform package are:

- The introduction of a new PE avoidance rule that will prevent multinationals from structuring their operations to avoid having a PE in New Zealand where one exists in substance.

- Stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income.

- Stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities. We also

propose shifting the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length, and extending the time bar (the period of time which Inland Revenue has to reassess a taxpayer) from four years to seven years for transfer pricing.

- A range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues). These are similar to some of the administrative powers provided under the UK and Australia's Diverted Profit Taxes but New Zealand's administrative measures are more targeted at the practical barriers faced by tax investigators as they will only apply when a multinational does not cooperate with a tax investigation.

13. Many of these proposals are similar to tax reforms that Australia has introduced in recent years. They are also broadly consistent with the OECD's BEPS Action Plan, although the specific proposals are tailored for the New Zealand environment to address issues that Inland Revenue has identified when investigating multinationals.

Private sector consultation

14. 15 submitters provided written submissions on the discussion document. The Treasury and Inland Revenue also met with six of these submitters to discuss their submissions.

General reaction

15. Overall, most submitters accepted in principle the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. However, they did raise issues with certain features of the proposed measures and made suggestions to make them more certain and better targeted.

16. Two of the 15 submitters welcomed the proposals as a positive step by the Government to ensure that all large multinationals are paying their fair share of tax.

17. The other 13 submitters were tax advisors or represent multinationals that could be negatively affected by the proposals. Their submissions were critical of some of the measures.

18. Some submitters argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented. As noted in the accompanying covering Cabinet Paper (*Tax measures to prevent base erosion and profit shifting*), there will be additional tax and compliance costs for some investors but these additional costs will mostly be borne by taxpayers engaging in BEPS activities and the overall benefits to New Zealand of addressing BEPS outweigh these costs.

19. As expected, most of the submitters opposed the administrative proposals to increase Inland Revenue's powers to investigate multinationals. However, we consider these new powers are necessary to ensure Inland Revenue can effectively enforce the new rules. These new powers include:

- Expanding Inland Revenue's ability to request information that is held by a related group member offshore. Submitters considered this proposal could unfairly penalise a New Zealand entity that may not be able to get the information from their multinational group members. However, we consider it is unacceptable for Inland Revenue's investigations to be frustrated because a multinational group fails to provide information that is under its control.

- Shifting the burden of proof for transfer pricing onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length. Submitters considered Inland Revenue had information regarding comparable transactions and should bear the burden of proof. However, shifting the burden of proof is consistent with the fact that the taxpayer holds the relevant information on their own transfer pricing practices. The burden of proof is already on the taxpayer for other tax matters and is also on the taxpayer for transfer pricing matters in most other OECD and G20 countries, including Australia. Because most multinationals already prepare transfer pricing documentation that satisfies the burden of proof for other countries, the additional compliance costs from this change are not expected to be substantial.

- Extending the time bar (the period of time which Inland Revenue has to adjust a taxpayer's transfer pricing position) from four years to seven years for transfer pricing. Submitters opposed this extension on the basis that it increased uncertainty and was out of step with the general time bar, which applies to other areas of tax. However, we are continuing to recommend the seven year rule. Having a longer time bar for transfer pricing cases is consistent with both Australia and Canada (who also have a special seven year time bar for transfer pricing) and reflects the information asymmetry that exists in transfer pricing cases (especially where taxpayers may hold relevant information offshore).

Changes made as a result of consultation

20. In response to submissions, we have updated the proposals to address many of the submitters' concerns while ensuring the measures are just as effective at combatting BEPS.

21. Many submissions focused on when the PE avoidance rule would apply. Submitters considered the proposal outlined in the discussion document applied too broadly and could have unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

22. We consider the PE avoidance rule should be more narrowly targeted at avoidance arrangements. We would like to consult further as to how best to achieve this.

23. Submitters also pointed out that the OECD has updated their model DTA to address PE avoidance and New Zealand is currently in the process of adopting this into some of our tax treaties by signing the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* and through negotiating new tax treaties. We agree that the domestic law PE avoidance rule will only be necessary when the relevant tax treaty does not yet include the OECD's new recommendation and propose narrowing the application of rule accordingly.

24. The PE avoidance rule would apply notwithstanding the relevant DTAs (that don't yet include the OECD's new model PE rule). We consider that this is acceptable for two reasons:

- The OECD's commentary to their model DTA contemplates that countries can adopt anti-avoidance rules and states that, as a general rule, there will be no conflict between such anti-avoidance provisions and the provisions of a DTA. An existing example of this is New Zealand's General Anti-Avoidance Rule which explicitly overrides our DTAs to allow New Zealand to combat tax avoidance arrangements. The PE avoidance rule would be a specific anti-avoidance rule, which would also be consistent with the principle in the OECD's commentary.

- The UK and Australia have already implemented similar PE avoidance rules in their domestic laws which override their DTAs and their treaty partners have not challenged this.

25. Another major point raised by submitters was the need to clarify the circumstances in which Inland Revenue would be able to reconstruct a taxpayer's transfer pricing position. We recommend clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.

26. Other significant changes made as a result of consultation were:

- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.

- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money" interest rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay tax that is in dispute.

27. The above changes will make the rules more certain and better targeted and are likely to be welcomed by submitters.

28. We also recommend widening the scope of the original proposal to deem an amount of income to have a New Zealand source under our domestic legislation if we have a right to tax the income under a DTA. The rule proposed in the discussion document was limited to income covered by the PE and royalty articles of our DTAs. We should extend the rule to all types of income that we can tax under a DTA – as Australia does. This ensures we can exercise a taxing right that we have negotiated under a DTA. We will consult further on this wider proposal in the next round of consultation.

29. These recommended changes will not affect the originally forecast revenue from implementing the transfer pricing and PE avoidance measures, which is $25m in 2018/19 and $50m per annum from 2019/20 (some of this revenue has already been included in the Budget 2017 forecasts).

30. We recommend Cabinet delegate authority to the Ministers of Finance and Revenue to make final decisions on the detailed design of the proposed rules. As we continue to design the detail of the proposals there will be further targeted consultation with interested parties.

Agency consultation

31. Inland Revenue and Treasury officials have consulted with the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment on this Cabinet paper.

Financial implications, human rights, administrative impacts, legislative implications, publicity

32. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

33. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

34. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

35. We recommend that the Cabinet Economic Growth and Infrastructure Committee:

1. **Note** that in March this year the Government released a discussion document called *BEPS – transfer pricing and permanent establishment avoidance* which proposed some detailed measures to improve our ability to tax multinationals that operate in New Zealand.

2. **Note** that in response to submissions we have made the proposed measures better targeted at the BEPS concerns without reducing the overall effectiveness of the proposed reforms.

3. **Agree** to introduce a new PE avoidance rule that will apply to large multinationals that structure their businesses to avoid having a PE (taxable presence) in New Zealand.

4. **Agree** to expand and strengthen the rules for taxing New Zealand-sourced income by:

   - deeming certain amounts of income to have a source in New Zealand if New Zealand has a right to tax that income under any applicable DTA;

   - introducing an anti-avoidance source rule which will broadly provide that, where another group member carries on a non-resident's business in New Zealand, the non-resident will be deemed to carry on that business itself for the purpose of determining whether its income from New Zealand customers has a New Zealand source; and

   - addressing a potential weakness of the life insurance source rules by ensuring that no deductions are available for the reinsurance of life policies if the premium income on that policy is not taxable in New Zealand, including where the income is not subject to New Zealand tax by operation of a DTA.

5. **Agree** to strengthen the transfer pricing rules so they align with the OECD's transfer pricing guidelines and Australia's transfer pricing rules. This involves amending New Zealand's transfer pricing rules so that:

   - they disregard legal form if it does not align with the actual economic substance of the transaction;

   - they provide Inland Revenue with a power to reconstruct transfer pricing arrangements which are not commercially rational because they include unrealistic terms that third parties would not be willing to agree to;

   - the legislation specifically refers to arm's length conditions;

- they refer to the latest OECD transfer pricing guidelines as guidance for how the rules are applied;

- the new legislation codifies the requirement for large multinationals to provide Inland Revenue with the information required to comply with the OECD's country-by-country reporting initiative;

- the time bar that limits Inland Revenue's ability to adjust a taxpayer's transfer pricing position is increased to seven years (in line with Australia);

- the burden of proof for demonstrating that a taxpayer's transfer pricing position aligns with arm's length conditions is shifted from Inland Revenue to the taxpayer (consistent with the burden of proof being on the taxpayer for other tax matters); and

- in addition to applying to transactions between related parties, the transfer pricing rules will also apply when non-resident investors "act in concert" to effectively control a New Zealand entity, such as through a private equity manager.

6. **Agree** to strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation by amending the Tax Administration Act 1994 to allow Inland Revenue to:

    - more readily assess the multinational's tax position based on the information available to Inland Revenue at the time;

    - collect any tax owed by a member of a large multinational group from any wholly-owned group member, provided the non-resident fails to pay the tax itself;

    - use section 17 of the Tax Administration Act 1994 to request information that is held offshore by another group member of the large multinational group;

    - use section 21 of the Tax Administration Act 1994 to deem an amount of income to be allocated to a New Zealand group member or PE of a large multinational group in cases where they have failed to adequately respond to an information request in relation to New Zealand sourced income (currently the existing power only applies in respect of deductible payments); and

    - impose a new civil penalty of up to $100,000 for large multinational groups which fail to provide requested information (which replaces the current $12,000 maximum criminal penalty).

7. **Note** that the fiscal consequences of the above measures are set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

8. **Delegate** authority to the Minister of Finance and the Minister of Revenue to make final decisions on the detailed design of the above measures.

9. **Agree** that the results of the decisions in recommendations 3-6 and 8 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Coversheet: BEPS – transfer pricing and permanent establishment avoidance rules

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
There are international concerns about multinationals not paying their fair share of tax. This is because some multinationals use base erosion and profit shifting (BEPS) strategies to report low taxable profits in New Zealand and other countries in which they operate. These BEPS strategies include arrangements between related parties which shift profits out of New Zealand (usually into a lower taxed jurisdiction). They also include arrangements which are designed to ensure New Zealand is not able to tax any income from sales here despite there being a physical presence in New Zealand in relation to the sales. These particular BEPS strategies are known as transfer pricing and permanent establishment (PE) avoidance. Finally, Inland Revenue faces administrative difficulties in investigating large multinationals.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The proposed approach is to adopt the package of measures outlined in the Government discussion document *BEPS – transfer pricing and permanent establishment avoidance (March 2017),* with some changes resulting from consultation, as the measures will: • ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand; • stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and • make it easier for Inland Revenue to investigate such multinationals.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit by receiving an additional $50 million of revenue per annum. Compliant businesses will benefit because the multinationals involved in transfer pricing and PE avoidance activities will no longer be able to achieve a competitive advantage. Also, the measures will support voluntary compliance by protecting the integrity of the tax system.

Where do the costs fall?
Multinationals which currently engage in BEPS activities will face a medium level of compliance costs. These taxpayers may choose to transition into more tax compliant agreements which will require restructuring costs; or they may apply for advance pricing agreements (APAs). However, the majority of multinationals are compliant and should not be materially affected by the proposals.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is a risk that foreign companies investing in New Zealand will view the proposals as complex and onerous, incentivising them to remove their existing personnel from New Zealand or to cease operating in New Zealand altogether. However, most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is limited certainty of evidence in relation to the problem of transfer pricing and PE avoidance arrangements. This is because such activities are often not directly observable in the absence of specific audit activity. However, Inland Revenue is aware of about 16 cases involved in these types of BEPS arrangements which are currently under audit. While there are only 20 New Zealand-owned multinationals that earn over the threshold for some of the main proposals (over EUR €750 million of consolidated global revenue), the European Union (EU) has estimated that there may be up to 6,000 multinationals globally

that do. However, we do not know how many of these global multinationals operate in New Zealand.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed *the BEPS – transfer pricing and permanent establishment avoidance rules* Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS – transfer pricing and permanent establishment avoidance rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem Our analysis has been limited somewhat by our inability to assess the exact size of the transfer pricing and PE avoidance structures in New Zealand. In common with BEPS activities generally, transfer pricing and PE avoidance is difficult to quantify as tax avoidance is often not directly observable. We consider that, while most multinationals are compliant, there is a minority that engage in transfer pricing and PE avoidance. Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not addressed. Furthermore, as New Zealand endorses the Organisation for Economic Co-operation and Development's (OECD) *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan), there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations. **Range of options considered** Our analysis of options has been primarily constrained by New Zealand's double tax agreements (DTAs). Under its DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines. **Assumptions underpinning impact analysis** The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of transfer pricing and PE avoidance arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs, and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.

Responsible Manager (signature and date):
Carmel Peters Policy Manager, Policy and Strategy Inland Revenue 13 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

BEPS refers to the aggressive tax planning strategies used by some multinationals to pay little or no tax anywhere in the world. This outcome is achieved when multinationals exploit gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In 2013, the OECD published its BEPS Action Plan which identified actions needed to address BEPS (including transfer pricing and PE avoidance), set deadlines to implement these actions, and identified the resources needed and the methodology to implement these actions. In 2015, the OECD released its final package of recommended actions for countries to implement to counter BEPS.

If no action is taken to counter transfer pricing and PE avoidance arrangements, multinationals that are currently engaging in these types of arrangements will be able to continue, and the number of these types of avoidance cases will continue to increase.

New Zealand's BEPS work

New Zealand is a supporter of the OECD/G20 BEPS project to address international avoidance and is advancing a number of the OECD/G20 BEPS recommendations.

In September 2016, the Government released the BEPS discussion document *Addressing hybrid mismatch arrangements*. In March 2017, the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*; along with the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*.

The *BEPS – Transfer pricing and permanent establishment avoidance* discussion document consulted on the Government's proposal to introduce a new set of tax rules to counter BEPS activities involving transfer pricing and PE avoidance. Many of the proposals follow the OECD's BEPS Action Plan recommendations (such as updating our transfer pricing legislation to align with the OECD's new transfer pricing guidelines).

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework ensures the tax system is not generally used to deliver incentives or encourage particular behaviours.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge is to ensure that our tax rules are up to date and result in multinational firms paying a fair and efficient amount of tax in New Zealand. Base protection measures, such as transfer pricing and PE rules, are important to protect the tax base and ensure that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

New Zealand's PE rules

New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules in conjunction with our DTAs. Under our DTAs, New Zealand is generally prevented from taxing a non-resident's business income unless the non-resident has a PE in New Zealand. This is the case even if that income has a source in New Zealand under our domestic legislation.

In general, New Zealand can only tax a non-resident multinational group on its sales here if both of the following conditions are met:

- The multinational group has a sufficient taxable presence in New Zealand. This means the group must operate in New Zealand either through a New Zealand-resident subsidiary (in which case the subsidiary is taxable on its income) or through a PE of a non-resident group member. A PE is basically a place of business of the non-resident, but it also includes an agent acting for the non-resident.
- Where a multinational operates in New Zealand through a PE of a non-resident group member, some of the non-resident's net profits from its sales can be attributed to its taxable presence here. This involves determining:
  - The amount of the non-resident's gross sales income which can be attributed to its PE here; and
  - The amount of the expenses which can be deducted from that income to determine the net taxable profits in New Zealand.

The non-resident must also have a sufficient taxable presence in New Zealand (if a DTA applies) for New Zealand to charge non-resident withholding tax on certain payments by the non-resident (such as a royalty) to other parties in connection with the New Zealand sales income.

New Zealand's transfer pricing rules

"Transfer pricing" refers to the use of cross-border payments between associated entities such as a parent and a subsidiary. Transfer pricing rules are therefore concerned with

determining the conditions, including the price (and therefore the tax liability), for transactions within a multinational group resulting in the allocation of profits to group companies in different jurisdictions.

New Zealand's transfer pricing legislation was first introduced in 1995 and is largely focused on the legal form of the transaction and adjusting the consideration that is paid to an arm's length amount (which can be zero). Due to the increased complexity and tax planning of cross-border intra-group trade over the last 22 years, New Zealand's existing transfer pricing rules are unable to adequately address some types of profit shifting.

General anti-avoidance rule (GAAR)

New Zealand also has a general anti-avoidance rule (GAAR) which effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. However, the GAAR is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own.

2.3 What is the policy problem or opportunity?

The problem of transfer pricing and PE avoidance

Some multinational companies operating in New Zealand exploit deficiencies in the current international tax system (both in New Zealand and abroad) by using transfer pricing and PE avoidance strategies to report low taxable profits in New Zealand despite carrying out significant economic activity here. Transfer pricing and PE avoidance can lead to unfairness and the substitution of low-taxed investors for tax-paying investors. This has the potential to reduce national income while doing little or nothing to reduce the overall pre-tax cost of capital to New Zealand or increase the overall level of investment. It also distorts the allocation of investment by favouring foreign investors who set out to game the system.

Transfer pricing avoidance

One of the major strategies used by multinationals to shift profits out of New Zealand and reduce their worldwide tax bills is transfer pricing. Related parties may agree to pay an artificially high or low price for goods, services, funding, or intangibles compared to the "arm's length" price or conditions that an unrelated third party would be willing to pay or accept under a similar transaction. By manipulating these transfer prices or conditions, profits can be shifted out of New Zealand and into a lower-taxed country or entity.

PE avoidance

Some multinationals reduce their New Zealand tax liability by structuring their affairs to avoid a PE arising, despite carrying on significant activity here.

Impacted population

These rules affect only taxpayers with foreign connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations. The impacted population is therefore predominately large companies.

Many of the proposed measures will apply only to multinational groups with over EUR €750 million of consolidated global revenue. While there are only 20 New Zealand-owned multinationals that earn this much, the EU has estimated that there may be up to 6,000

multinationals globally that do. However, we do not know how many of these global multinationals operate in New Zealand.

Transfer pricing and PE arrangements in New Zealand

Inland Revenue is aware of about 16 cases of transfer pricing and PE avoidance currently under audit that collectively involve about $100 million per year of disputed tax. These cases show our existing rules are vulnerable and Inland Revenue considers that the use of avoidance arrangements will increase if the weaknesses in the current rules are not strengthened. Furthermore, as New Zealand endorses the OECD's BEPS Action Plan, there is an expectation that we will take action against BEPS and implement a number of the OECD's recommendations.

Inland Revenue's judgement is that the transfer pricing and PE proposals can expect to add $50 million a year of revenue to the forecasts. This $50 million per year estimate relates to the fact that the proposals will make it more difficult to avoid tax under the transfer pricing and PE rules and easier to find and assess any remaining avoidance cases. This should reduce future avoidance arrangements and free up investigator resources. The changes will also result in more revenue being able to be assessed from any multinationals which continue to use transfer pricing or PE avoidance arrangements.

2.4 Are there any constraints on the scope for decision making?

Our analysis of options has been primarily constrained by New Zealand's DTAs. Under our DTAs, New Zealand can only tax non-residents on business profits if they have a PE in New Zealand. The OECD guidance permits departure from this only in respect of tax avoidance. We have also been somewhat constrained by the fact that New Zealand endorses the OECD's transfer pricing guidelines.

2.5 What do stakeholders think?

Submissions on the discussion document

The Government received 16 submissions on the discussion document from key stakeholders.[1] We also met with six of the main submitters to discuss their submissions in more detail.

Many submitters strongly opposed the proposals that increased Inland Revenue's power to investigate large multinationals. Others argued that the proposals could have a detrimental effect on New Zealand being an attractive investment destination and should not be implemented.

However, most submitters accepted the need for measures to address the transfer pricing and PE avoidance issues identified in the discussion document. Some submitters even welcomed the proposals as a positive step by the Government to ensure multinationals pay their fair share of tax.

Further consultation

Following Cabinet decisions in July 2017, we are planning to undertake further public

[1] Most of the submitters were stakeholder groups, tax advisors, and foreign-owned firms that would be affected by the proposals.

consultation on outstanding policy issues, technical design details, and an exposure draft of selected parts of the planned BEPS bill.

Section 3: Options identification

3.1 What options are available to address the problem?

Officials have identified four mutually exclusive options to address the problem:

- Option 1 – Status quo
- Option 2 – MLI and the OECD's transfer pricing guidelines
- Option 3 – Diverted profit tax
- Option 4 – Discussion document proposals (as amended through consultation)

Option 1 is the only non-regulatory option. The other options involve implementing an international agreement or changing New Zealand tax legislation.

Option 1: Status quo

This option would retain the existing tax rules for multinationals (as described in the sections above). Under this option, Inland Revenue would continue trying to enforce the existing rules and/or apply the GAAR to challenge tax avoidance arrangements.

Option 2: MLI and the OECD's transfer pricing guidelines

Option 2 is to rely on the combination of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI)[2] and the OECD's transfer pricing guidelines without amending our domestic law. Under this option, any PE avoidance issues would be addressed under the OECD's new PE definition in the MLI, and any transfer pricing issues would be addressed by applying the OECD's new transfer pricing guidelines.

Option 3: Diverted profits tax

Option 3 is to adopt a diverted profits tax (DPT). A DPT is a separate tax on the "diverted profits" that arise from transfer pricing and PE avoidance. It is levied at a penal rate, compared with income tax, and has greatly enhanced assessment and collection powers. Both the UK and Australia have already implemented a DPT to target multinationals engaging in BEPS strategies. DPTs are intended to incentivise taxpayers to pay the correct amount of income tax under the normal rules rather than to raise revenue by themselves.

Option 4: Discussion document proposals (as amended through consultation)

This option involves adopting the package of measures proposed in the discussion document, with some changes resulting from consultation. The discussion document proposals have taken certain features of a DPT and combined them with the OECD's BEPS measures and some domestic law amendments to produce a package of measures that is tailored for the New Zealand environment. The intention is that this approach would be as effective as a DPT in addressing transfer pricing and PE avoidance in New Zealand, but it would do so within our current frameworks and with fewer drawbacks. Under this option, we would introduce:

- an anti-avoidance rule that will prevent multinationals from structuring their operations

[2] The MLI allows countries to quickly and efficiently implement a number of the OECD's BEPS Action Plan measures that can only be implemented through changes to DTAs, without having to bilaterally renegotiate their existing DTAs.

to avoid having a PE (a taxable presence) in New Zealand where one exists in substance;

- stronger transfer pricing rules which will adjust related party transactions if they do not align with the actual substance of the multinational's economic activities; shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arm's length; and extend the time bar for transfer pricing from four years to seven years;
- stronger "source rules" so New Zealand has a greater ability to tax New Zealand-sourced income; and
- a range of administrative measures that will strengthen Inland Revenue's powers to investigate large multinationals (with at least EUR €750m of global revenues) that do not cooperate with a tax investigation (such as allowing Inland Revenue to request information that is held by an offshore group member).

Consultation

These four options were identified prior to consultation. The discussion document proposed the adoption of a package of reforms combining elements of a DPT with the OECD's recommendations and some domestic law amendments (option 4). The discussion document discussed the status quo (option 1) and the DPT (option 3). Some submitters proposed that the better approach would be to sign the MLI and apply the OECD's transfer pricing guidelines without amending our domestic law (option 2).

In response to consultation we have refined the proposals so they are better targeted at BEPS arrangements with less compliance costs and fewer unintended impacts on compliant taxpayers engaging in ordinary, commercial dealings.

Significant changes made as a result of consultation were:

- More narrowly targeting the PE avoidance rule at avoidance arrangements (we will consult further on how best to achieve this).
- Clarifying that the test for reconstructing an arrangement would be based on the corresponding test in the OECD's transfer pricing guidelines.
- The PE avoidance rule will only apply where an applicable DTA does not include the OECD's widened PE definition (as in cases where the OECD's new PE definition is included, the proposed PE avoidance rule will be unnecessary).
- The anti-avoidance source rule will be more narrowly targeted at the existing issues Inland Revenue has identified with the source rules.
- We have decided not to proceed with the proposal to require multinationals to pay disputed tax upfront as we agree with submitters that the existing "use of money interest" rates that Inland Revenue charges on unpaid tax provide a sufficient incentive to pay any tax which has been assessed.

The above changes are likely to be welcomed by submitters.

Evidence from Australia's reforms

Australia's recent experience updating their transfer pricing laws (in 2013) and introducing a new Multinational Anti-Avoidance Law (MAAL) demonstrates the effectiveness of tax reforms

to address PE avoidance and transfer pricing issues.

Australia's MAAL came into effect on 11 December 2015 and prevents multinationals from structuring their affairs to avoid having a PE in Australia. It is very similar to our proposed PE avoidance rule.

As of 4 June 2017, the Australian Tax Office (ATO) had identified 221 taxpayers they believed to be shifting profits to a non-resident group member resident in a low-tax jurisdiction. Of these 221 taxpayers, the ATO has cleared 102. Furthermore, since the MAAL was introduced, 18 companies with PE avoidance structures have restructured their affairs to bring their sales onshore – and a further 11 are currently working with the ATO to restructure.

According to the ATO, as a result of the introduction of the MAAL, an additional AUS$6.4 billion worth of assessable income will now be reported in Australia. This translates into $100 million a year in additional tax revenue for Australia.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible;
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible;
- Neutrality – the tax system should bias economic decisions as little as possible;
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way; and
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality, and fairness impacts without some increase in compliance costs and so there are some trade-offs that were, and continue to be, considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

Two options were ruled out of scope due to their radical nature, namely:

- cancel New Zealand's DTAs; and
- prevent multinationals from selling products in New Zealand if they were suspected of involvement in BEPS activities.

The former would harm New Zealand exporters and outbound investors. The latter would not only harm New Zealand consumers (as they would no longer be able to import certain goods), but it would also violate New Zealand's trade agreements.

Section 4: Impact Analysis

	Option 1: Status quo	Option 2: MLI and the OECD's transfer pricing guidelines	Option 3: Diverted profit tax	Option 4: Discussion document proposals (as amended through consultation)
Efficiency of compliance	**0**	- Option 2 imposes increased compliance costs on taxpayers as a result of applying the MLI and the new transfer pricing guidelines.	- - Option 3 imposes ongoing compliance costs on taxpayers as it requires them to provide information or concede transfer pricing outcomes in transfer pricing audits.	- Option 4 imposes increased compliance costs on taxpayers as they will be required to conform to the additional administrative measures. See below for further details.
Efficiency of administration	**0**	**0** We do not expect there will be increased administrative costs under this option as the reforms largely change the way some taxpayers self-assess the income and deductions they report to Inland Revenue.	- We expect there will be increased administrative costs under this option as a DPT is a separate tax from an income tax.	**0** We do not expect there will be increased administrative costs under this option. The proposed administrative measures should also make it easier for Inland Revenue to investigate uncooperative multinationals. See below for further details.
Neutrality	**0**	+ Option 2 will remove some of the tax benefit of currently observed transfer pricing and PE avoidance opportunities in New Zealand. See below for further details.	+ Option 3 will remove the tax benefit of currently observed transfer pricing and PE avoidance opportunities involving New Zealand. However, it may have a negative impact on investment certainty for taxpayers.	+ + Option 4 will remove the tax benefit of all currently observed transfer pricing and PE avoidance opportunities involving New Zealand. See below for further details.
Fairness and equity	**0**	+ Option 2 has some fairness benefits as it ensures that some taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	**0** Option 3 has some fairness benefits as it ensures that taxpayers able to use transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others. See below for further details.	+ Option 4 has the most fairness benefits as it ensures that all taxpayers able to use observed transfer pricing and PE avoidance arrangements cannot reduce their tax liability and pass their tax burden to others.
Sustainability	**0**	+ Option 2 will remove some, but not all, of the current transfer pricing and PE establishment opportunities involving New Zealand.	+ Option 3 will remove current transfer pricing and PE establishment opportunities involving New Zealand. See below for further details.	+ + Option 4 will remove current transfer pricing and PE establishment opportunities involving New Zealand and is well-targeted at the problems that have been observed by Inland Revenue in New Zealand.
Overall assessment	Not recommended	Not recommended	Not recommended	**Recommended**

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Option 2 (MLI and the OECD's transfer pricing guidelines)

- **Neutrality:** The effect of this option will be limited as the MLI will not cover many of our DTAs and New Zealand's current transfer pricing legislation does not allow us to apply some of the new transfer pricing guidelines.
- **Fairness and equity:** While option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements.

Option 3 (Diverted profits tax)

- **Fairness and equity:** While option 2 has some fairness benefits, it also has some significant fairness detriments owing to its penal tax rate, reduced taxpayer rights, and wide scope. Further, a DPT could also impact on the perception of the fairness of New Zealand's tax system for multinationals investing into New Zealand.
- **Sustainability:** Compared to the other options it would provide less certainty for, and impose more compliance costs on, taxpayers.

Option 4 (Discussion document proposals (as amended through consultation))

- **Efficiency of compliance:** It is also highly likely that a number of taxpayers will choose to restructure their affairs and/or apply APAs.
- **Efficiency of administration:** The proposals may place a higher demand on Inland Revenue's transfer pricing team and more transfer pricing specialists may be required to deal with this.
- **Neutrality:** This option will ensure multinationals engaged in BEPS activities are not tax-advantaged over more compliant domestic and non-resident businesses. This will provide some efficiency gains.

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 4 (discussion document proposals (as amended through consultation)) is the best option to combat transfer pricing and PE avoidance.

Option 4 will improve the neutrality of New Zealand's tax system by eliminating the ability for multinationals to engage in aggressive transfer pricing and PE avoidance schemes to receive tax benefits. Option 4 will:

- ensure that multinationals cannot structure their affairs for the purpose of avoiding a taxable presence in New Zealand;
- stop companies from shifting profits out of the New Zealand tax base through artificial arrangements; and
- make it easier for Inland Revenue to investigate such multinationals.

Option 4 will also improve the equity and fairness of New Zealand's tax system. Multinationals engaging in BEPS activities are currently able to structure their affairs to receive unintended tax benefits placing them at a competitive advantage over more compliant multinationals or domestic companies. As a result, these more compliant multinationals and domestic companies end up suffering a greater tax burden. Option 4 will therefore ensure that the tax burden is shared more equally among taxpayers.

While option 4 will impose additional tax and compliance costs on some taxpayers, it is important to note that some of the measures will only apply to large multinational groups with over EUR €750 million of consolidated group turnover. Submitters on the discussion document argued that the imposition of higher tax payments may make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, as a number of like-minded countries throughout the OECD are undertaking similar BEPS measures, we believe that any impacts on foreign direct investment into New Zealand will not be material and that implementing the proposals in option 4 remains in New Zealand's best economic interests (see further discussion in section 5.3 below).

Option 1 (status quo) was preferred by a number of submitters to the discussion document. However, retaining the current rules would mean that those multinationals engaging in aggressive transfer pricing and PE avoidance structures would be able to continue, and the number of these types of avoidance cases would continue to increase. While New Zealand has a GAAR (see above in section 2.2), it is unlikely to be effective at addressing all transfer pricing and PE avoidance structures on its own. This is because applying the GAAR often leads to resource-intensive court cases and it may be difficult to show that certain avoidance structures fail the Parliamentary contemplation component of the GAAR.

Option 2 (MLI and the OECD's transfer pricing guidelines) was the option suggested by many submitters. However, we consider that adopting the OECD's recommendations on their own (without corresponding domestic amendments) would not effectively address the issue of transfer pricing and PE avoidance. First, New Zealand's existing transfer pricing legislation does not contemplate an ability to apply some important aspects of the new OECD's transfer pricing guidelines. This means that Inland Revenue would only be able to

apply the guidelines to the extent that our current domestic rules allow. Domestic law changes would likely be needed to adequately address the issue. Second, while option 2 has some fairness benefits, it will not prevent all taxpayers from using such arrangements. This is because the MLI will only apply where both countries choose to adopt it – and many of New Zealand's trading partners do not intend to adopt it. It is therefore important that New Zealand adopt its own PE avoidance measure to supplement the MLI, otherwise there would still be a gap for multinationals to exploit. Third, the OECD's BEPS measures do not address issues specific to New Zealand, such as issues with our current source rules and the practical difficulties of taxing multinationals (such as information asymmetry and the administrative costs of taxpayer disputes).

Option 3 (diverted profits tax) is not recommended. This option would provide less certainty for, and impose significant compliance costs on, taxpayers. This is because a DPT is a separate tax at a much higher rate than the standard company tax rate and includes stringent enforcement mechanisms. This means an investor may find themselves being charged a much higher rate of tax (plus interest and penalties) that can be difficult to challenge or credit against prior year losses or taxes charged by other countries. This increased risk and uncertainty may reduce their willingness to invest in New Zealand (compared to more certain investments elsewhere).

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*

Additional costs of proposed approach, compared to taking no action			
Regulated parties	<u>Compliance costs:</u> increased costs understanding the rules and applying them to transactions and structures for multinationals which currently engage in BEPS activities. Such taxpayers may choose to restructure which will involve compliance costs and the demand for APAs may increase. <u>Revenue</u>	Medium. However, they should only affect multinationals currently engaged in BEPS activities. **$50 million per year**	Medium Low*

Regulators	Administrative costs: Inland Revenue staff, particularly investigators and transfer pricing specialists, need to develop their knowledge of the proposals.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Revenue	**$50 million per year**	Low*
Non-monetised costs	Compliance costs Administrative costs	Medium Low	Medium High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Tax payable: we are confident of collecting a significant amount of revenue from the proposals. Reduced administrative costs: More powers to both request multinationals' offshore information and to investigate uncooperative multinationals should make investigating these types of BEPS arrangements easier.	**$50 million per year** Low	Low* High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	**$50 million per year**	Low*
Non-monetised benefits	Reduced administrative costs Improved voluntary compliance by supporting the integrity of the tax system in a high profile area.	Low Low	Low Low

*Note that the evidence for the $50 million figure is a conservative estimate made in light of the behavioural uncertainty associated with introducing transfer pricing and PE avoidance rules together with the fact that the full extent of these types of avoidance arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be significantly higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?
During consultation on the discussion document, some submitters raised concerns that adopting the proposed measures would have a detrimental impact on New Zealand being an attractive investment destination. In particular, these submitters were concerned that the proposed measures introduce complex and onerous rules which may incentivise foreign companies to remove their existing personnel from New Zealand, thereby reducing GDP and lowering employment levels. The higher tax payments and compliance obligations resulting from these measures will inevitably make New Zealand a less attractive investment location for multinationals engaged in BEPS arrangements. However, at the same time, these multinationals should not be allowed to exploit weaknesses in our tax rules to achieve a competitive advantage over more compliant multinationals or domestic firms. Furthermore, arbitrary reductions in tax, depending upon the opportunism of taxpayers, are likely to distort the allocation of investment into New Zealand. New Zealand is also undertaking these BEPS measures in line with a number of like-minded countries throughout the OECD. Given this, we believe any impacts on foreign direct investment into New Zealand will not be material and implementing these measures remains in New Zealand's best economic interests. It is also highly unlikely that foreign companies will remove their existing personnel from New Zealand as a result of these proposals. Most of the affected foreign companies are dependent on having personnel in New Zealand to arrange their sales. Without personnel on the ground, they would not be able to service their New Zealand market. It is also unlikely that they would cease to operate in New Zealand altogether.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?
Yes, option 4 (to adopt the package of measures in the discussion document) conforms to Government's 'Expectations for the design of regulatory systems'.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its *Tax Information Bulletin* (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018.

One exception is a grandparenting rule that exempts from application of the rules all advance pricing agreements (APAs) existing prior to the application date.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider the planned application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we plan on meeting with taxpayers and preparing detailed guidance materials.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation, and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

When the MAAL was introduced in Australia, 18 companies restructured their affairs to bring their sales onshore (and a further 11 are currently working with the ATO to restructure). We envisage a similar response to our proposals whereby a number of taxpayers will restructure their affairs to report their sales in New Zealand. We also expect more taxpayers to apply for APAs as a result of the new transfer pricing rules. However, it will be difficult to assess the true impact of the transfer pricing proposals.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is significantly unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

In confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

BEPS – addressing hybrid mismatch arrangements

Proposal

1. This paper seeks Cabinet approval to introduce new tax rules to address the problem of hybrid mismatch arrangements. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

Executive summary

2. Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

3. The OECD, as part of its base erosion and profit shifting (BEPS) Action Plan, published in late 2015 its final report on hybrid mismatch arrangements. This report recommended that countries enact a comprehensive set of rules to neutralise the benefit of hybrid mismatch arrangements affecting their tax base.

4. The UK has legislated the OECD recommendations into their domestic law and Australia is committed to do the same. The EU has also issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

5. The OECD recommendations will not apply to the vast majority of taxpayers. They will not apply to purely domestic firms. They apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of the OECD recommendations is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

6. The Government released a discussion document in September 2016 called *Addressing Hybrid Mismatch Arrangements* which proposed that the OECD recommendations be adopted in New Zealand and asked for feedback on how that should best be done. Since receiving submissions to this document, officials have engaged stakeholders in targeted consultation on specific design issues relating to the proposal. Consultation has resulted in some of the proposals being modified, such as a proposed exclusion from the rules for New Zealand businesses that operate offshore only through a simple branch structure. Nevertheless, many taxpayers affected by these proposals will still oppose them. Some would prefer to see a targeted approach, which would only tackle hybrids that have already been observed in New Zealand.

7. However, in order to send the clear message that using hybrid mismatch arrangements should not produce a tax advantage, we are recommending that Cabinet agree to a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New Zealand context. To do otherwise may simply encourage the ongoing use of hybrids not covered by any targeted proposal. Other issues raised through the consultation process, and which are likely to attract the most comment (such as the application of the rules to foreign trusts) are set out in paragraphs 24-38 of this paper.

8. We are further recommending that hybrids rules be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Background

BEPS

9. New Zealand's BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan,. Its final package of reports was released in October 2015. The Action Plan is a multifaceted approach intending to encourage countries to close many (but not all) of the avenues multinational companies currently use to reduce their worldwide tax liability, and to improve the information available to governments when they deal with multinational companies, without changing the fundamental principles for the taxation of international trade and investment.

10. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

Hybrid mismatch arrangements

11. Hybrid mismatch arrangements are a significant base erosion and profit shifting (BEPS) strategy used by some multinational companies to pay little or no tax anywhere in the world on some or all of their income. They are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation.

12. One way in which this double non-taxation can arise is through a payment being deductible for a payer in one country but not included as taxable income for the payee in the other country. Another way double non-taxation can arise is by way of a single payment being deducted against different income streams in two countries.

13. Double non-taxation of this kind is difficult to deal with, because it can be achieved even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues. It is often difficult to determine which of the countries involved has lost tax revenue through the use of a hybrid mismatch arrangement, but there is undoubtedly a reduction of worldwide tax paid.

The OECD's response

14. The OECD has made a number of recommendations as to how countries can improve their domestic rules to prevent mismatches arising and neutralise their effect when they do arise. These recommendations relate to Action 2 of the OECD/G20 BEPS Action Plan: Neutralising the Effects of Hybrid Mismatch Arrangements.

15. The OECD recommends two kinds of rules. The first are rules specifically designed to reduce the likelihood of hybrid mismatches arising. The second are "linking rules", which apply to payments that give rise to a deduction in more than one country, or which give rise to a deduction in one country but are not taxed as income in another country due to a hybrid mismatch. These generally only apply to:

- arrangements between related parties (25% or more commonly owned) or control groups (50% or more commonly owned); or
- structured arrangements - generally, arrangements between non-associated parties which intentionally exploit such mismatches.

16. These linking rules are divided into "primary" and "secondary" responses. Primary responses have precedence, with secondary responses being used if the country that has the primary right does not have hybrid rules. This primary/secondary structure is important for ensuring that all hybrids with a connection to New Zealand are effectively countered irrespective of where the counterparty is based.

17. The OECD has also developed an additional BEPS Action 2 report that makes a number of recommendations as to how countries can deal with the problem of branch mismatch arrangements which is closely related to the hybrid mismatches issue.

Other countries

18. The UK has introduced into its domestic law rules that reflect a broad adoption of the OECD recommendations. Australia has proposed to do the same and, as part of its 2017 Budget, committed to introduce rules that are effective by 1 January 2018 or six months following Royal assent.[1] The EU has issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules by 1 January 2020. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

Hybrids discussion document

19. On 6 September 2016, the Government released a discussion document entitled "Addressing hybrid mismatch arrangements" seeking feedback on proposals to address hybrid mismatch arrangements in line with the OECD recommendations [CAB-16-MIN-0442].

20. 20 submissions were received on the discussion document. Most submitters accepted the need for some hybrid rules, with some submitters expressing support for New Zealand to take action in line with the OECD hybrids package, subject to various provisos, including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. The majority of submissions argued that we should only implement rules to counter hybrid mismatches actually observed in New Zealand, rather than the full suite of OECD recommendations.

[1] As set out in paragraph 59, Australia has indicated that it is unlikely to implement OECD recommendation 5 at this stage, but may do so in the future if integrity concerns arise.

Comment

Implementing the full OECD hybrids package

21. As set out in the cover Cabinet paper (*Tax measures to counter base erosion and profit shifting*), we are recommending that Cabinet agree to a comprehensive implementation of the OECD's proposed solutions to the hybrid and branch mismatch problem, , even though there was limited evidence of some of the structures being used in New Zealand. We are of the view that the OECD proposals are in New Zealand's best interests, as enacting these recommendations will improve fairness, reduce harmful distortions in investment patterns, increase tax revenue, and will also address the risk of taxpayers using new hybrid mismatch opportunities if only the more common techniques are addressed initially.

22. In making this recommendation, we recognise that these proposals involve considerable complexity, which will not generally be welcomed by those taxpayers affected. However, we are comfortable that there are a number of factors that outweigh these concerns:

- We are proposing to modify the OECD recommendations when it is appropriate to do so for the New Zealand context. Examples are ensuring New Zealand companies with simple foreign branch structures are not caught by the rules (see "application of hybrids rules to foreign branches" below), not applying the rules to purely domestic firms, and not introducing rules when an adequate New Zealand provision already exists.

- We are recommending that officials continue to consult on a few particular issues that have the potential to ease the compliance costs of the proposals before we make a final decision on them under Cabinet delegated authority. These consist of elective options which would in effect allow existing hybrids to be treated as simple equity investments.

- Despite the necessary complexity, the underlying principle is clear – using hybrid mismatches as a tax-efficient means of inbound, outbound or conduit investment is not appropriate.

- We are recommending that relevant parties be consulted on exposure drafts of key aspects of the legislation. This is intended to facilitate workable legislation that is understandable to those applying it.

- In almost all cases, the complexity will be optional. Taxpayers can avoid having to deal with these rules by undertaking simple debt or equity funding.

23. Some of the other more significant issues relating to this proposal are set out below. Those are followed by a brief explanation of each of the OECD recommendations and the principles behind them. The appendix contains a series of detailed aspects of the proposals that we are also seeking Cabinet's agreement to. These details have been consulted on with interested parties, and are consistent with the general recommendations set out below.

Significant issues

Foreign trusts

24. As set out in the cover Cabinet paper, we are recommending that foreign trusts be included within the scope of these rules in circumstances where their treatment outside of New Zealand means income of the trust is not included in a tax calculation anywhere in the world. This is not because they are foreign trusts, but because in those circumstances they are "reverse hybrids" according to the OECD recommendations (see the discussion on OECD Recommendation 5.2, below). The same rule would equally impose tax on New Zealand limited partnerships that fit within the reverse hybrids definition.

25. We are aware that foreign trusts have recently had a new set of disclosure rules apply to them following the 2016 Government Inquiry into Foreign Trust Disclosure Rules. In this respect, adding another regulatory regime to the industry now is unfortunate timing. To reflect the fact that these trusts have recently undergone significant compliance costs, and to give the foreign trust and limited partnership industries more time to understand the implications of the proposed rules, we are recommending a delayed effective date for New Zealand reverse hybrids of 1 April 2019.

Application of hybrid rules to foreign branches

26. The way in which the OECD recommendations are written would in some circumstances deny a New Zealand company the ability to offset a loss from its foreign branch against its New Zealand income. This is an issue that some submitters have been very concerned about.

27. We have made various modifications to the OECD recommendations to address this issue, including clarifying that taxpayers who have simple offshore branch structures do not present a hybrid mismatch problem and so are not covered by the rules.

Imported mismatches

28. OECD recommendation 8 suggests countries include an "imported mismatch" rule when implementing hybrid and branch mismatch rules. Imported mismatch rules apply when the New Zealand resident is not directly involved in the hybrid mismatch, but the benefit of a mismatch is "imported". Some submitters on the discussion document viewed this particular recommendation as over-reach, highly complex and impractical.

29. To address these concerns, we recommend that the introduction of the imported mismatch rule be different for "structured" and "unstructured" arrangements. Structured arrangements are deliberately entered into to obtain a tax advantage, so should be implemented at the same time as the rest of the hybrid rules. By contrast, unstructured arrangements are ones where the New Zealand benefit is not the primary reason for entering into the arrangement. We recommend that the unstructured rule has a delayed implementation date of 1 January 2020. By this date, we expect that the EU countries, the UK, and Australia will all have hybrid rules. Delaying the implementation of the unstructured rule until those countries have similar rules will reduce the costs involved in complying with the rule in New Zealand because, by that time, multinationals that are also operating in those countries should already be complying with their equivalent rules, and also because payments

to those countries will not be subject to the imported mismatch rule at all. More details regarding the imported mismatch rule are contained later in this paper.

Over-taxation by reason of the imposition of NRWT

30. The OECD recommends that countries apply the hybrid rules without regard to any withholding tax collected on the relevant payments. In situations where New Zealand imposes non-resident withholding tax (NRWT) on an interest payment that is also denied a deduction under the hybrid rules, there may be over-taxation.

31. As far as our officials are aware, Australia is not planning on departing from the OECD approach. An argument for this approach is that in the majority of cases taxpayers can simply switch to simpler structures and arrangements and be subject to only single taxation. The OECD approach is also less complicated. Nevertheless, there has been an argument from some submitters that the hybrid rules should be modified in New Zealand so as to remove this potential over-taxation for taxpayers that choose to remain in hybrid structures.

32. We recommend that in the case of a hybrid financial instrument, there needs to be further consideration of the possibility of letting taxpayers treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We recommend that Cabinet delegate the authority to determine the appropriateness of such an approach to us to decide after receiving further advice. For hybrid arrangements other than financial instruments, we are less concerned about the imposition of NRWT. Although there may be some over-taxation, in many cases this will simply be a timing issue.

Grandparenting for certain instruments issued by banks to the public

33. We recommend that there be an exception to the rules for certain hybrid instruments ("hybrid regulatory capital") issued by banks and insurance companies either directly or indirectly to third party investors, in partial satisfaction of the capital requirements imposed on those companies by regulators (such as the Reserve Bank and its Australian equivalent, APRA). We recommend that such instruments issued before the date of the discussion document release (6 September 2016) should not be subject to the hybrid rules until the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

34. This grandparenting date is different to the date proposed in Australia, which is 8 May 2017 (the day before their Federal Budget). We consider differing from Australia is justified in this case. The Australian Government had made public the fact that it was considering how such instruments should be taxed, and did not make an announcement until its 2017 Budget. In New Zealand the hybrids discussion document released on 6 September stated that such instruments would be subject to the hybrid rules. To grandparent instruments issued after the New Zealand discussion document may be seen as encouraging taxpayers to enter into aggressive structures after the government has stated an intention to change the rules but before that change is enacted. We are wary of creating an expectation that such arrangements will be grandparented.

Opaque election for foreign hybrid entities

35. The private sector has proposed that a New Zealand investor in a foreign hybrid entity be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand to remove the hybridity and put that entity outside the scope of the rules. Our initial view is that

excluding simple branch structures from the rules, and the ability of hybrid participants to restructure their arrangements, may make such an election redundant. Nevertheless, we have asked officials to continue their consideration of how such an election may work in practice, including whether the costs of administering it for what may be a relatively small group are justified. We recommend that Cabinet delegate to us the authority to decide on the appropriateness of an opaque election.

Application of rules to branch mismatch arrangements

36. Consultation on branch mismatches has taken place but has not been as comprehensive as that for the remainder of the hybrid proposals. In part this is because such mismatches are less significant for New Zealand, and in part because the OECD draft report on branches was released at around the same time as the New Zealand discussion document, and the proposal was therefore less well developed. Nevertheless, we recommend that New Zealand implement rules that are consistent with the OECD recommendations on branch mismatches (this is also consistent with the approach that has been taken by the UK and which we understand will be taken by Australia). Branch mismatches arising from foreign branch losses are a double non-taxation risk and to leave them out of these proposals would expose the tax base to future risk. The remainder of the branch mismatch concerns addressed are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

De minimis rule

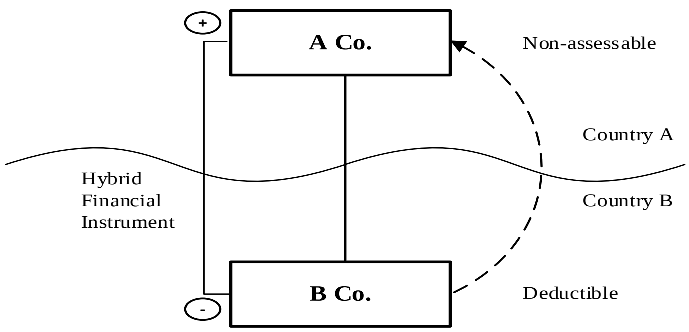
37. We recommend that there be no general de minimis for the hybrid rules. We believe that a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules. This means that any de minimis would likely be ineffective in practice because the other country would still counter the hybrid mismatch using their secondary response right. Also, our proposals will ensure that simple branch structures (the most likely beneficiaries of a de minimis) are not within the scope of the rules.

38. We do however recommend that there should be specific de minimis rules for reverse hybrid entities established in New Zealand (see paragraphs 55-57).

OECD recommendations

Hybrid financial instrument rules (Recommendations 1 and 2)

39. The following diagram illustrates a typical hybrid financial instrument issued between related parties A Co and B Co.



40. Double non-taxation arises in this situation because the payment on the hybrid financial instrument is deductible (as interest) in Country B but not taxable (because it is treated as an exempt dividend) in Country A.

41. OECD recommendation 2 is a specific recommendation that countries should amend their domestic law so that dividend payments that are deductible to the payer (B Co) should be treated as ordinary income for the payee (A Co).

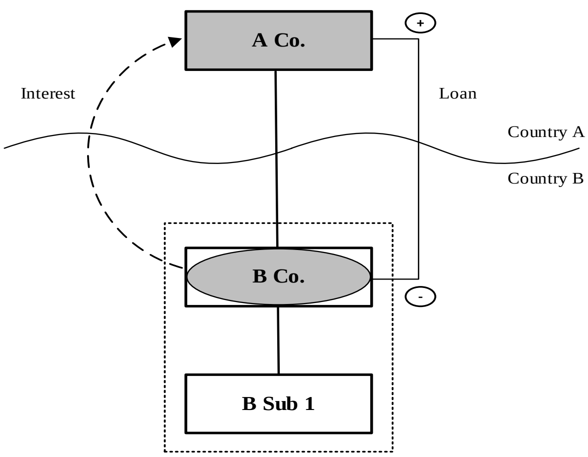
42. New Zealand already has a rule that switches off the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. We recommend that this rule be expanded to also apply if the foreign payer receives tax benefits similar in nature to a deduction.

43. We also recommend introducing rules in line with the general principles of OECD recommendation 1. This means that, in relation to hybrid financial instruments that are structured or between related parties, we should deny a New Zealand payer a deduction for the payment (when New Zealand is Country B) to the extent it is not taxed to a non-resident payee. It is in respect of this aspect of recommendation 1 that we are considering the election to treat interest payments as dividends. In addition, when New Zealand is Country A and Country B does not have hybrid rules, we should tax the New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit.

44. We also recommend that when there is a timing mismatch that allows a deduction to be claimed in one country in a period that is significantly earlier than the period in which income is included in the other country, the rules above should also apply.

Disregarded hybrid payments rule (Recommendation 3)

45. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor (Country A) but opaque for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the hybrid entity.



46. The interest payment by B Co is deductible in the hybrid entity country (Country B) but disregarded in the investor country (Country A) because Country A sees B Co as being part of A Co and therefore not capable of making a payment to itself. However, as the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can

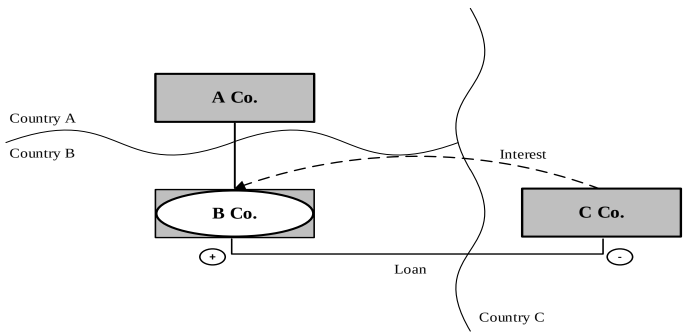
therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

47. We recommend introducing rules in line with the general principles of OECD recommendation 3 in order to prevent double non-taxation arising from a payment by a hybrid entity. We recommend that, when New Zealand is Country B and payments are deductible here but are disregarded for tax purposes in Country A (and the payments are part of a structured arrangement or made to a person in the same control group), we should deny a deduction for the payment. Similarly, if New Zealand is Country A and the non-resident payer in Country B has not been denied a deduction for the payment under similar rules, we should tax the receipt by the New Zealand payee as ordinary income.

48. We recommend that deductions denied and income included by the above rules should be reversible to the extent that the hybrid entity has earned "dual inclusion income", being income taxed in both Country A and Country B. This is because this dual inclusion income is included as income in both countries so the corresponding deduction should also be allowed in both countries. The dual inclusion income can be earned in the same period as the payment is made, in an earlier period, or in a later period.

Reverse hybrid rules (Recommendations 4 and 5)

49. A reverse hybrid entity is an entity which is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the reverse hybrid.



50. If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co.

51. We recommend introducing rules in line with the general principles of OECD recommendation 4 to prevent double non-taxation arising from a payment to a reverse hybrid. We recommend that, when New Zealand is Country C, the New Zealand payer be denied a deduction for a payment to a reverse hybrid if the payment would have been taxed if paid directly to the investor (A Co). This rule would only apply when the payer, payee and investor are all in a control group or the payment is part of a structured arrangement.

52. OECD recommendation 5.1 is that countries should change their domestic law so that they tax residents on income not taxed in another country due to its being earned by a reverse hybrid. In other words, when New Zealand is Country A, we should tax A Co on the income of B Co if Country B does not tax it (because it treats B Co as transparent for tax purposes).

53. We recommend that New Zealand should have rules that are in line with the general principles of recommendation 5.1 and other international tax principles. New Zealand already has controlled foreign companies (CFC) rules that in most cases would prevent a reverse hybrid entity mismatch outcome from occurring when a New Zealand resident is the investor (A Co). We recommend that Cabinet delegate authority to us to determine whether our current CFC rules should be enhanced to deal with any forms of reverse hybrid income not currently dealt with, in line with the general principles of recommendation 5.1.

54. OECD recommendation 5.2 is that countries should change their domestic law so that they tax income which is earned by a reverse hybrid entity established in their country. So, when New Zealand is Country B, we recommend introducing rules in line with the general principles of this recommendation. As set out in the cover Cabinet paper and in paragraphs 24-25, this will require amendments to existing law regarding New Zealand limited partnerships and foreign trusts, which can be reverse hybrid entities depending on the tax treatment in the investor country.

55. In regards to limited partnerships, we recommend taxing the partnership income of a non-resident partner if they are in a control group with the partnership and not taxed on their share of the partnership income because their jurisdiction views the income as earned by the partnership as a separate taxpayer from the partner. This rule will only apply if the limited partnership has total foreign-sourced income of greater than $10,000 or 20% of its total income. This de minimis rule, and the corresponding one for foreign trusts in the following paragraphs, is consistent with the recently-enacted de minimis rule for foreign sourced income of look-through companies.

56. In regards to foreign trusts, we recommend taxing the foreign-source trustee income of the trust, provided that the non-resident settlor and trust are all in a control group. Many family trusts would meet this requirement. Foreign source trustee income will only be taxed if the non-resident settlor is not taxed on the trustee income in their residence country simply because the income is earned by the New Zealand trustee rather than the settlor directly. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income.

57. We also recommend taxing the foreign-source beneficiary income of a non-resident beneficiary of a foreign trust if they are not taxed on the income in their residence country because that country views the income as earned by the trustee and not the beneficiary. This rule will only apply if the trust has total foreign-sourced income of greater than $10,000 or 20% of its total income, and the non-resident beneficiary is part of a control group with the trust/trustee. In relation to both beneficiary and trustee income, tax would only be imposed if there was no-one else in the same control group required to include that income in their taxable income.

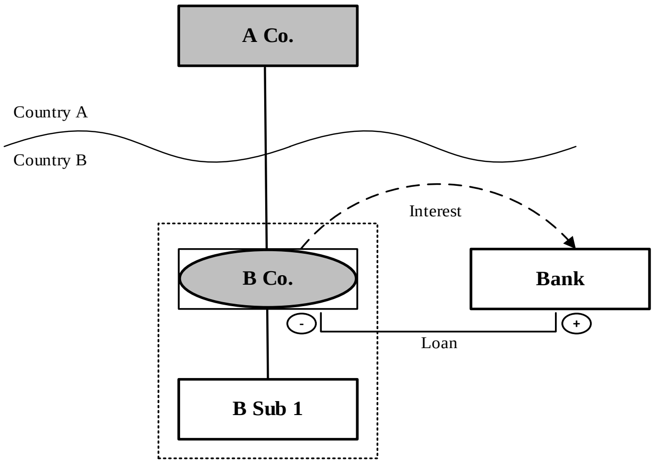
58. OECD recommendation 5.3 is that countries should consider improvements to record keeping and disclosure rules for tax transparent entities established in their country. Following the 2016 Government Inquiry into Foreign Trust Disclosure Rules, the disclosure rules for foreign trusts have been enhanced. New Zealand is regularly reviewed by the OECD to ensure that we are meeting international standards in this area. The Government will

continue to work with the OECD and make improvements to disclosure rules as necessary to ensure compliance with best practice.

59. We note that Australia has indicated that it is unlikely to implement any of recommendation 5 at this point – this is largely because they see their existing rules as adequate. However, they have reserved the right to do so in the future if integrity concerns arise. We are not as confident that our existing rules in relation to reverse hybrids are adequate to prevent mismatches from occurring. As set out above, we are concerned that leaving 'gaps' in our rules exposes our tax base to risks that can be mitigated by following all of the OECD's recommendations.

Hybrid entities – double deductions (Recommendation 6)

60. In addition to being capable of generating a deductible/non-inclusion hybrid mismatch, a hybrid entity can also be used to generate a double deduction mismatch. A diagram illustrating this possibility follows, where B Co is the hybrid entity.



61. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment can offset income earned by B Sub 1, which is in a tax consolidated group with B Co. This is a double non-taxation outcome because a single payment has been deducted against different income in two countries.

62. In Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand [CAB-17-MIN-0164]. This means that, when New Zealand is Country A, the deductions in B Co would not flow back to New Zealand if it is possible for that deduction to also offset Country B income that does not flow back to A Co (in this case, the income of B Sub 1).

63. Nothing in this paper is inconsistent with that specific decision. However, as mentioned in paragraph 26-27, we are recommending a slightly narrowed approach to the OECD recommendation 6, whereby simple structures involving a New Zealand company with only an offshore branch would not fall within the scope of the rules.

64. We also recommend implementing a rule that would, when New Zealand is Country B, disallow the losses of a foreign-owned New Zealand hybrid entity or branch when the country of the owner (Country A) has not denied the loss.

65. As with the recommendation 3 rule, denial of a deduction under the recommendation 6 rule should be reversed to the extent that the hybrid entity has dual inclusion income, whether in the current period, an earlier period, or a later period.

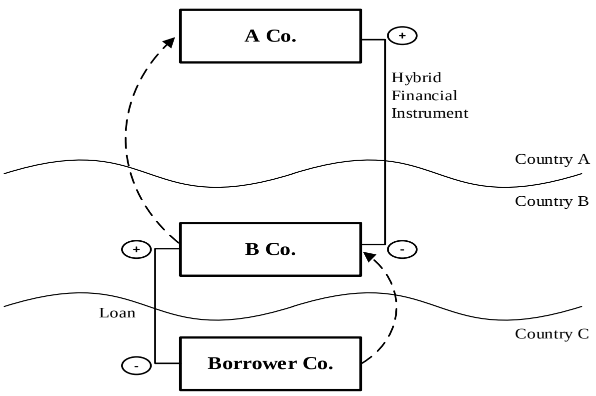
Dual resident entities (Recommendation 7)

66. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. Expenditure incurred by a company that is a resident of two different countries can potentially be used in each country to offset non-dual inclusion income, which is income taxed only in that country. This would achieve the same double deduction outcomes that hybrid entities can produce under recommendation 6 (above).

67. New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

Imported mismatches (Recommendation 8)

68. As set out in paragraphs 28-29, we recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment that funds another payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



69. In this example, New Zealand is Country C. The loan between A Co and B Co generates a deduction in Country B, with no corresponding income inclusion in Country A. This is a double non-taxation outcome. However, this tax mismatch is not counteracted because neither Country A nor Country B has hybrid rules. The tax benefit of the A/B mismatch helps fund the seemingly benign arrangement between B Co and the New Zealand entity (Borrower Co).

70. The imported mismatch rule would require New Zealand, as Country C, to deny a deduction for interest payments from Borrower Co to B Co to the extend they do not exceed the payments under the hybrid financial instrument between B Co and A Co. This is an integrity measure that prevents New Zealand's other hybrid rules from being circumvented.

Without this rule, businesses in Country A can simply avoid our proposed rules by going from A to C via B.

71. We recommend that the imported mismatch rule applies to both structured arrangements that are designed to produce an imported mismatch outcome, and unstructured arrangements within a control group. However, because unstructured arrangements may not be deliberately contemplated, we are recommending a delayed implementation for those arrangements until more countries, the EU countries in particular, have hybrids rules in place.

Agency consultation

72. The consultation on this project has been explained in the cover Cabinet paper. Briefly, there have been two rounds of consultation: one on the proposals in the discussion document; and a further round with selected submitters on branch mismatches and some of the detailed aspects set out in this paper.

Financial implications

73. The proposed hybrid rule denying double deductions for foreign hybrid entities is estimated to increase tax revenue by $50 million per year from the 2019-20 year onwards. These amounts are already included in the forecasts as per Budget 2017 (CAB-17-MIN-0164).

74. In addition, the proposed approach to grandparenting certain hybrid instruments as discussed at paragraphs 33-34 is expected to generate a total of $71 million over four years which is not currently included in the forecasts. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

75. The combined revenue impact of all proposals is estimated as:

$ million – increase / (decrease)							
Vote Revenue	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 and out years**
Foreign hybrid entity double deductions (already included in forecast)	0	0	25	50	50	50	50
Hybrid instruments – grandparenting (new adjustment to forecasts)	0	0	19	19	19	14	0
Total revenue effect	**0**	**0**	**44**	**69**	**69**	**64**	**50**

Human rights, administrative impacts, legislative implications, publicity

76. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

Impact Analysis Requirements

77. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

78. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

Recommendations

79. We recommend that Cabinet:

1. **Agree** that for payments under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:

    a. to deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (OECD recommendation 1 primary rule); and
    b. if a non-resident payer has not been denied a deduction for the payment under similar rules, to tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (OECD recommendation 1 defensive rule).

2. **Agree** to expand New Zealand’s current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (OECD recommendation 2).

3. **Agree** that for payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognised under the tax law in the payee country because the payment is disregarded under that law:

    a. to deny a deduction for the payment if made by a New Zealand payer (OECD recommendation 3 primary rule);
    b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, to include the payment in ordinary income of the New Zealand resident (OECD recommendation 3 defensive rule);
    c. to allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against income that is included as income in both relevant countries (“dual inclusion income”).

4. **Agree** to deny a New Zealand payer a deduction in relation to payments made to a reverse hybrid entity in the same control group as the payer or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid entity (OECD recommendation 4).

5. **Agree** that New Zealand should tax the income of a reverse hybrid established in New Zealand (such as a foreign trust or a limited partnership) to the extent that:

   a. the reverse hybrid income is not subject to tax in another jurisdiction (OECD recommendation 5.2); and
   b. the total foreign sourced income of the reverse hybrid exceeds the greater of $10,000 or 20% of the total income of the reverse hybrid.

6. **Agree** to the following in relation to double deduction outcomes produced by branches and hybrid entity structures:

   a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branch if there is another entity in that foreign country whose income is capable of being offset against the losses of the hybrid entity or branch and that income is not taxable in New Zealand (modified OECD recommendation 6 primary);
   b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (OECD recommendation 6 defensive); and
   c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

7. **Agree** to deny a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income (OECD recommendation 7).

8. **Agree** to deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, except to the extent that the payment is made to a country that has hybrid mismatch rules (OECD recommendation 8).

9. **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.

10. **Agree** that the effective date of the rule relating to unstructured imported mismatches (part of recommendation 8 above) should be delayed until 1 January 2020.

11. **Agree** that the application of the rule relating to New Zealand reverse hybrids (recommendation 5 above) should be for income years beginning on or after 1 April 2019.

12. **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:

    a. issued to satisfy the regulatory capital requirements imposed by New Zealand or Australian law;
    b. directly to, or are traceable to, issues to the public; and
    c. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

13. **Note** that the fiscal consequences of agreeing to recommendation 12 above is set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

14. **Agree** to the detailed design proposals set out in the appendix to this paper.

15. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on further detail of these proposals, or to amend the detail in the appendix, provided any such decisions are not contradictory with the principles set out in recommendations 1 to 12, without further reference to Cabinet.

16. **Agree** to delegate authority to the Minister of Finance and the Minister of Revenue to make final policy decisions on the following policy issues without further reference to Cabinet:

    a. whether New Zealand's controlled foreign company (CFC) rules should be modified to include as attributable foreign income all income of a reverse hybrid entity which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is treated as fiscally transparent in that country (OECD recommendation 5.1);
    b. whether New Zealand can and should include a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes; and
    c. whether, the payer under a hybrid financial arrangement for which a deduction is denied, should be allowed to treat the payment as a dividend for purposes of both (but not only one of) the non-resident withholding tax and the imputation credit rules.

17. **Agree** that the results of the decisions in recommendations 1-16 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue

Appendix

List of detailed design decisions

	OECD Recommendations 1 and 2
1.	A person who receives a payment which is deductible to the payer in another country will not be entitled to the benefit of any imputation credit attached to the payment.
2.	When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency, the deduction denied will take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes, and any net income from the instrument including any foreign currency fluctuations will be non-taxable.
3.	When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the taxpayer will not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.
4.	To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee entity under another country's controlled foreign company (CFC) regime, the payer will be allowed a deduction for the payment.
5.	If a person holds a FIF interest as part of a share repo arrangement, that person will be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest.
6.	If a person holds New Zealand shares as part of a share repo arrangement, where the borrower is a non-resident, the person is not entitled to the benefit of an imputation credit attached to any dividends on the shares.
7.	OECD recommendation 1 will only apply to timing mismatches if: • the mismatch arises on an instrument with a term of 3 years or more or on an instrument that has been extended to beyond 3 years; and • the lender is not accounting for the payment, for tax purposes, on a reasonable accrual basis; and • it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months

	of the end of the period in which the expenditure is incurred.
8.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.
9.	Interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.
10.	There will be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

	OECD Recommendation 3
11.	Any foreign currency fluctuations recognised for tax purposes in relation to a financial arrangement denominated in a foreign currency will be taken into account when denying a deduction to a New Zealand payer.
12.	Dual inclusion income will be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it will not include income which is protected from New Zealand tax by a foreign tax credit.
13.	For the purposes of denying a deduction for a New Zealand payer, full taxation of income under a CFC regime will prevent income being treated as not taxable to a payee and will qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.
14.	When an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that will be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible.
15.	The ability to claim a deduction in relation to a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company’s ownership since the time the relevant deduction was incurred or deemed expenditure arose.
16.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted.

17.	Denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules.
18.	A deduction would be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs.
19.	Where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income will be reversed in a later year when there is dual inclusion income earned through the hybrid entity.

	OECD Recommendation 4
20.	Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.
21.	Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.
22.	To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.
23.	Non-resident withholding tax will continue to be applied to payments, despite the denial of the deduction
24.	Interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

	OECD Recommendation 5.2
25.	Tax the partnership income of a non-resident partner of a New Zealand limited partnership if the non-resident partner is in a control group with the partnership and the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not by the partner.
26.	Tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that: • the beneficiary is in the same control group as the trustee; and • the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and • the income is not subject to tax as the income of any person other than

	the trustee (such as the beneficiary or settlor).
27.	Tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that: • the settlor is in the same control group as the trustee; • the settlor would be taxed on the trustee income if it held the trust assets directly; and • the income is not subject to tax as the income of any person other than the trustee.
28.	Include a de minimis so that none of the above recommendation 5.2 rules apply if the total foreign sourced income of the trustee does not exceed the greater of $10,000 and 20% of the total income of the trust.

	OECD Recommendation 6
29.	There will be a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity.
30.	A deduction will be allowed in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country
31.	Income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit.
32.	Double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch will be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
33.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.
34.	Amendments will be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are

	deducted.
35.	Denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	OECD Recommendation 7
36.	Amend existing consolidation and loss grouping rules for dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.
37.	Double deduction amounts and dual inclusion income amounts will be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
38.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred.
39.	Denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	OECD Recommendation 8
40.	When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied will ignore any foreign currency fluctuations on the instrument.
41.	Interest that is denied a deduction under recommendation 8 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules

	General design and definitional matters
42.	A coordination rule will be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.
43.	A specific anti-avoidance rule will be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.

Coversheet: BEPS - Hybrid mismatch arrangements

Advising agencies	*Inland Revenue, The Treasury*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
A tailored adoption of the OECD's BEPS Action 2 recommendations will comprehensively deal with the problem of hybrid mismatch arrangements while making modifications and variations to take into account what is appropriate for the New Zealand context. This tailored solution is sustainable and achieves gains to efficiency and fairness, while minimising compliance costs where possible. There will be a significant benefit in adopting a solution which is adopted by other countries and which will therefore be easier for multinational businesses to understand and comply with.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis. There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

Where do the costs fall?
Taxpayers that use hybrid mismatch arrangements will face a medium level of compliance costs. These may be up-front, in the form of restructuring costs to transition to more straightforward (non-hybrid) arrangements, or they may be ongoing in the case of taxpayers that keep their hybrid mismatch arrangements in place and must apply new tax rules in order to comply with the law.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is some risk of taxpayer noncompliance with the proposed rules. However, the risk of taxpayers being inadvertently caught by the proposed rules has been minimised due to the design of the preferred regulatory option which seeks to exclude the most simple offshore structures (foreign branches). More generally, the impacts have been reduced through the proposals taking into account the New Zealand context and adjusting the OECD-recommended rules as needed.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Not every type of hybrid arrangement that would be countered by the proposals has been observed in New Zealand. However, Inland Revenue is aware of some historic and current hybrid arrangements, and there is a very high likelihood there are others that relate to New Zealand and will be affected by this regulatory proposal.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the BEPS – hybrid mismatch arrangements Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS - Hybrid mismatch arrangements

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem Our analysis has been limited somewhat by our inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand. Inland Revenue is aware of some mismatch arrangements, but the full extent of the problem is unknown. This is because evidence of the problem primarily comes from Inland Revenue's investigations staff. Under current law these staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals. **Range of options considered** Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations. **Assumptions underpinning impact analysis** The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of hybrid mismatch arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.
Responsible Manager (signature and date):
Paul Kilford Policy Manager, Policy and Strategy Inland Revenue 12 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinational groups to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter base erosion and profit shifting (BEPS).

Hybrid mismatch arrangements

Hybrid mismatch arrangements arise when taxpayers exploit inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. The OECD's BEPS package includes Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. Hybrid mismatch arrangements are prevalent worldwide and are an important part of the base erosion and profit shifting strategies used by multinational companies. If no action is taken by the international community to counter these types of arrangements they are likely to continue to be used to avoid worldwide taxation and drive economic inefficiencies and unfairly distributed tax burdens.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations.

In September 2016 the Government released a BEPS discussion document: *Addressing hybrid mismatch arrangements* which proposed adoption of the OECD Action 2 recommendations in New Zealand and sought submissions on how that should be done. In March 2017 the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*.

As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand. This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions.

At the same time, Cabinet noted that the reforms proposed in the BEPS documents would be progressed, subject to modification in consultation, for implementation from 1 July 2018. Cabinet also noted that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later in 2017.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

Company tax and international rules

The company tax system is designed to be a backstop for taxing the personal income of domestic investors. Company tax is deducted at 28%, but New Zealand based investors can claim imputation credits for tax paid by the company when the income is taxed upon distribution at the personal level. At the same time, the company tax is designed as a final tax on New Zealand-sourced income of foreign investors and foreign-owned companies earning New Zealand-sourced income.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge in the area of international tax is to ensure that multinational firms pay a fair and efficient amount of tax in New Zealand. Anti-avoidance rules and base protection measures are important part of ensuring that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

2.3 What is the policy problem or opportunity?

The problem of hybrid mismatch arrangements

Businesses can use hybrid mismatch arrangements to create tax advantages through exploiting inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. For example, using a hybrid entity or a foreign branch, a single expense may be deducted in two different jurisdictions, potentially reducing the tax payable on two different streams of income. Another example is a payment that is tax-deductible in one jurisdiction with no corresponding taxable income in the jurisdiction where the payment is received. However it is achieved, the result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates when compared with a straightforward arrangement that is seen consistently by both relevant countries. Hybrid mismatch arrangements also have the effect of subsidising international investment relative to domestic investment, which distorts the efficiency of global markets.

Since releasing its final recommendations on hybrid mismatch arrangements, the OECD expanded the scope of BEPS Action 2 to include branch mismatches. Branch mismatch arrangements are a result of countries approaching the allocation of income and expenses between a branch and a head office in different ways. Branch mismatch arrangements can also result in a reduction in the overall taxation of a corporate group, so are similar in effect to hybrid mismatch arrangements.

It is important to note that the policy problem is limited to circumstances when global tax is reduced as a result of a hybrid mismatch. This project does not address other mechanisms that taxpayers may use to lower their global tax liability, such as the use of low-tax jurisdictions to trap income.

Hybrid mismatch arrangements in New Zealand

New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the effects of a hybrid mismatch arrangement. However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way. Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements.

New Zealand also has some specific rules in its domestic law that go some way to addressing particular recommendations made by the OECD in relation to hybrid mismatch arrangements.

Inland Revenue is aware of a significant volume of hybrid mismatch arrangements involving New Zealand. For example, the amount of tax at issue in recent litigation for a prominent type of hybrid financial instrument was approximately $300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to the most prominent hybrid entity structure results in approximately $50 million less tax revenue for New Zealand per year.

2.4 Are there any constraints on the scope for decision making?

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Consistent with the OECD approach, the analysis has been focused on arrangements between related parties or where a hybrid mismatch has been created through a structured arrangement between unrelated parties.

We have also chosen to restrict the policy thinking to cross-border activity. Purely domestic hybrid mismatches (some of which are contemplated by the OECD Action 2 final report) are outside the scope of this regulatory proposal.

2.5 What do stakeholders think?

Stakeholders

Stakeholders of this regulatory proposal are primarily taxpayers (typically multinational businesses that have hybrid mismatch arrangements) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules. The proposed rules affect only taxpayers with foreign

connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

Another stakeholder of this regulatory proposal is the OECD, which is aiming to eradicate hybrid mismatch arrangements to the extent possible. This goal can only be achieved through countries adopting hybrid mismatch rules of some kind and neutralising the mismatches that arise when different sets of rules apply to the same transaction or entity. In addition, other countries that have enacted or are proposing to enact hybrid mismatch rules (for example, Australia and the United Kingdom) will be interested in the interaction between their own hybrid mismatch rules and any rules that New Zealand introduce into law.

The Reserve Bank of New Zealand (RBNZ) is interested in the regulatory proposal to the extent that it affects bank regulatory capital.

Submissions to discussion document

There were 20 submissions made to the September 2016 Government discussion document. Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions of some variety. However, a greater number of submitters were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

Further and ongoing consultation

We have engaged in approximately a dozen workshops (with the Corporate Taxpayers Group and Chartered Accountants Australia and New Zealand) and attended various other meetings with private sector submitters (including the New Zealand Bankers' Association) in order to discuss specific design issues relating to hybrid mismatch arrangements.

We have also consulted with officials representing Australia and the United Kingdom, as well as the OECD secretariat, on an ongoing basis to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation.

We have also consulted with the Reserve Bank.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Section 3: Options identification

3.1 What options are available to address the problem?

Four options were considered in the development of this regulatory proposal. These options are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) New Zealand aligns itself with the OECD recommendations in dealing with hybrid mismatch arrangements.

None of the options (with the exception of the status quo option) are non-regulatory options. This is because our judgment is that the policy problem of hybrid mismatch arrangements cannot be addressed without changing tax rules, and that is something that can only be done through the use of legislation (as per section 22(a) of the Constitution Act 1986).

These options are what we consider other countries dealing with hybrid mismatch arrangements will consider in their policy development process. The United Kingdom and Australia can both be said to have chosen their own version of option 2. Some other countries have had rules to deal with hybrid mismatches that predate the OECD's work in this area.

Status quo: No action

This option relies on New Zealand's existing law (including the GAAR) to counter hybrid mismatch arrangements and avoids the increased compliance costs and administrative costs of the other options. The status quo option also contemplates that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to New Zealand.

Option 1: Strict adoption of OECD recommendations

The OECD recommendations as set out in its BEPS Action 2 report are a comprehensive set of principle-based rules to counteract all types of hybrid mismatch arrangements. Option 1 is to strictly adopt those recommendations as described by the OECD into New Zealand domestic law. This option would deal with the range of hybrid mismatch arrangements targeted by the OECD to the extent they are found in or affect New Zealand. It would have the advantage of interacting well with other countries that similarly adopt the OECD recommendations into their domestic law.

Option 2: Tailored adoption of OECD recommendations

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the New Zealand context. This option bears close relation to Option 1 as it involves introducing OECD-consistent hybrid rules unless there is a compelling reason to depart from the OECD approach. Thus, this option would solve the policy problem while ensuring that particular New Zealand issues are addressed.

Option 2 also recognises that there are some instances where New Zealand's existing tax laws are sufficient (or can be made sufficient with relatively minor amendment) to achieve the effect intended by an OECD recommendation.

Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid

enacting rules targeted at arrangements which are not currently seen in New Zealand.

Consultation

These four options were identified prior to consultation. The September 2016 discussion document proposed adoption of the OECD recommendations (options 1 and 2) and sought feedback on how that should be done. The document stated the Government's alternative options as option 3 and maintaining the status quo and concluded that they were not the best way forward. Consultation has affected the nature of option 2 in particular and has been helpful for options analysis generally.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible
- Neutrality – the tax system should bias economic decisions as little as possible
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality and fairness impacts without some increase in compliance costs and so there are some trade-offs that were and continue to be considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

We ruled out designing a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This is for reasons of international compatibility and to save compliance costs.

Section 4: Impact Analysis

	Status quo: No action	Option 1: Strict adoption	Option 2: Tailored adoption	Option 3: Targeted rules
Efficiency of compliance	**0**	**- -** Option 1 has a significant compliance burden because some of the OECD recommendations as drafted would not mesh well with New Zealand's existing tax laws.	**-** Option 2 imposes increased compliance costs on taxpayers and advisors, but is focused on reducing those costs where possible.	**-** Option 3 imposes increased compliance costs on taxpayers and advisors, but by its nature it reduces those costs in proposing rules that only address currently observed exploitation of hybrid mismatches.
Efficiency of administration	**0**	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	**0** We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.
Neutrality	**0**	**++** Option 1 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	**++** Option 2 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	**+** Option 3 will remove the tax benefit of currently observed hybrid mismatch opportunities involving New Zealand. This will likely provide some efficiency gains. However, other hybrid mismatch arrangement opportunities will remain available. This means that, depending on the extent to which taxpayers respond to an option 3 approach by simply moving into "uncovered" tax-efficient hybrid structures, there will still be some inefficient allocations of investment due to ongoing hybrid mismatch arrangements.
Fairness and equity	**0**	**+** Option 1 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	**+** Option 2 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	**+** Option 3 has fairness and equity benefits as it ensures that taxpayers able to use currently observed hybrid mismatch arrangements cannot reduce their tax liability. However, this option's fairness impact depends on the behavioural effects of introducing these rules to a greater extent than options 1 and 2.
Sustainability	**0**	**++** Option 1 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	**++** Option 2 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	**+** Option 3 will remove currently known hybrid mismatch arrangement opportunities involving New Zealand. However, this option's sustainability is limited. It will leave some hybrid mismatches unaddressed, which may be exploited at a later date by opportunistic taxpayers.
Overall assessment	Not recommended	Not recommended	**Recommended**	Not recommended

Key:

++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?
We consider that option 2 is the best option for addressing the problem of hybrid mismatch arrangements. It is an internationally consistent, proactive option which delivers net benefits to New Zealand greater than that of the other options considered. Option 2 will improve the neutrality of New Zealand's tax system. Businesses that are able to exploit hybrid mismatch arrangements can currently operate at lower effective tax rates when compared with other businesses. This can result in a 'hybrid' business crowding out more productive investment and making international investment decisions based on whether a mismatch is available rather than commercial grounds. In addition, the imposition of higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrid mismatches is likely to be less efficient than imposing more moderate taxes across all economic actors. By eliminating the tax benefit of hybrid mismatch arrangements in a comprehensive way, these inefficiencies can be removed. In a related sense, option 2 will help to improve the equity and fairness of the New Zealand tax system. Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally. Option 2 will also have revenue collection benefits. The New Zealand tax revenue loss caused by the use of hybrid mismatch arrangements is difficult to estimate because the full extent of arrangements involving New Zealand is unknown and because the behavioural effects of introducing hybrid mismatch rules are difficult to ascertain. However, the tax revenue at stake is significant in the cases that Inland Revenue is aware of. Importantly, the case for New Zealand to adopt the OECD recommendations is strengthened by the fact that other countries have enacted, or are proposing to enact, hybrid mismatch rules. This is because a hybrid mismatch arrangement involving a New Zealand counterparty may still be neutralised by the other country if they have a 'secondary' right to counteract under OECD principles. In that case, the tax benefit of the hybrid mismatch would be eliminated, but the tax collected would be by the counterparty country. In these circumstances, New Zealand would be better off having its own hybrid mismatch rules so that it can collect revenue when it has the priority to do so under the OECD recommendations. Whether New Zealand or the counterparty country collects any additional revenue as a result of implementing the rules depends on the actions taken by the affected business. Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch

rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as "unstructured imported mismatches". This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

Accordingly, the compliance costs of the regulatory proposal are to be minimised to the extent possible, while still introducing a comprehensive set of rules to deal with the range of OECD-identified hybrid mismatches. This is where option 2 shows its advantage over option 1 which we view as having similar efficiency, fairness and revenue benefits. Option 1 would result in relatively higher compliance costs because the OECD recommendations are designed as a general set of best-practice rules and, in regards to their detail, are not necessarily optimal for individual countries such as New Zealand. When compared with option 1, option 2 ensures that the rules are workable and appropriate for the New Zealand tax environment.

It is also important to note that the ongoing compliance costs relating to this regulatory issue are expected to be optional in the majority of cases. The proposed rules will apply to taxpayers who use a hybrid mismatch arrangement after the rules become effective. Those taxpayers will generally have the option of incurring one-off costs to restructure into non-hybrid arrangements and remove themselves from the scope of the proposed rules.

Any higher tax payments resulting from the non-status quo options will make cross border investment less attractive for taxpayers using hybrid mismatch arrangements. However, these taxpayers should not be allowed to exploit hybrid mismatches to achieve a competitive advantage over taxpayers that do not use hybrid mismatch arrangements (such as purely domestic firms). Further, a significant number of New Zealand's major investment partners have introduced or will introduce hybrid mismatch rules. Other countries adopting these rules means that in many cases the tax efficiency of hybrid mismatch arrangements in New Zealand will be negated through the operation of the other country's rules on the counterparty, As a result, we believe that any impacts on inbound and outbound cross border investment from introducing hybrid mismatch rules in New Zealand will be low.

The status quo option would involve the least complexity and lowest compliance costs. However, similar to the cross-border investment discussion above, taxpayers whose groups deal with New Zealand's major trading partners that are adopting hybrid mismatch rules would have to understand the impact of those rules. The additional complexity of New Zealand having hybrid mismatch rules would therefore be lessened by the international momentum in this area.

Option 3 is an option that was preferred by many submitters to the Government discussion document on hybrid mismatch arrangements. Submitters pointed out that many of the structures considered by the OECD to be problematic have not been seen in New Zealand and therefore do not need to be counteracted. They also argued that the OECD recommendations are complex and have the potential for overreach. We do not think a targeted approach would serve New Zealand well when compared with option 2. The OECD recommendations are a coherent package intending to deal to the problem of hybrid mismatch arrangements exhaustively. Deliberately omitting aspects of the recommendations from New Zealand's response may cause taxpayers to exploit those remaining hybrid mismatch opportunities (which may even be seen as tacitly blessed). To the extent that happens, the efficiency, revenue, and fairness benefits of option 3 would be eroded. In

addition, other countries such as the United Kingdom and Australia have introduced or are intending to introduce a relatively comprehensive set of hybrid mismatch rules. If New Zealand does the same it will ensure our rules are internationally comparable and that they interact well with the rules of other countries without significant compliance issues. By favouring option 2, we also have consulted extensively on the OECD recommendations and how they should best be introduced into New Zealand law. This consultation has enabled us to design suitable modifications to the OECD recommendations to reduce complexity and compliance costs, limit overreach, and in some cases, increase the efficiency of the outcomes.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment***: nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Increased costs from understanding the rules and applying them to taxpayers' transactions and structures. Or, restructuring costs of transitioning to non-hybrid arrangements to fall outside the scope of the rules.	Medium	Medium
	Tax payable: Foreign hybrid entity double deduction structures are included in the rules and we are confident of collecting a significant amount of revenue from the disallowance of that type of hybrid mismatch arrangement.	Approximately $50 million per year on an ongoing basis	Low*
Regulators	Administrative costs: Inland Revenue staff, particularly investigations staff, need to develop their knowledge of the hybrid mismatch rules.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised	Compliance costs	Medium	Medium

costs	Administrative costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Revenue collected from tax payable item described above.	Approximately $50 million per year on an ongoing basis	Low*
	Reduced administrative costs: Less investigations and disputes resources spent on hybrid mismatch arrangements using the general anti-avoidance law (GAAR).	Low	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised benefits	Reduced administrative costs	Low	High

*Note that the evidence for the $50 million figure is strong, but it is a conservative estimate made in light of the behavioural uncertainty associated with introducing hybrid mismatch rules together with the fact that the full extent of hybrid mismatch arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?

As discussed above, allowing the use of hybrid mismatch arrangements is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders as it is something that is fundamental to the tax system itself.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 2 (tailored adoption of OECD recommendations) conforms to the expectations for the design of regulatory systems document.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its Tax Information Bulletin (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018. The major exceptions are:

- the proposed rule for "unstructured imported mismatch arrangements", which we recommend be delayed until income years starting on or after 1 January 2020; and
- the proposed rules applying to New Zealand "reverse hybrids", which we recommend be delayed until income years starting on or after 1 April 2019.

Another exception we recommend is a grandparenting rule that exempts from application of the rules (until the next call date) hybrid financial instruments issued by banks as regulatory capital (in Australian or New Zealand) to third party investors before the discussion document release date of September 2016.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider an application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. Audit staff will need to familiarise themselves with the proposed rules and how they operate in practice. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their hybrid mismatch arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we are minimising compliance costs where possible under our tailored adoption of the OECD recommendations. For example, and as mentioned above, we have delayed the application date of the unstructured imported mismatch rule contained in the OECD recommendations to acknowledge that it would be significantly more difficult and costly to comply with than the other rules if it applied at the outset.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

However, it may be difficult to assess the true impact of this regulatory proposal. This is because many taxpayers using hybrid mismatch arrangements may rearrange their affairs to fall outside the scope of the proposed rules. It will be difficult to measure the full extent of this behavioural effect.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.

SUBMISSIONS

Addressing hybrid mismatch arrangements

Submissions received for the Government's discussion document *Addressing hybrid mismatch arrangements* (September 2016).

Number	Submitter
001	JJL Hoogenboom
002	Andrea Black
003	Olivershaw Limited
004	Chartered Accountants Australia and New Zealand
005	KPMG
006	Westpac New Zealand Limited
007	Fisher & Paykel Healthcare Limited
008	Bank of New Zealand
009	Deloitte
010	Corporate Taxpayers Group
011	ANZ Bank New Zealand Limited
012	ASB Bank Limited
013	Insurance Australia Group Limited
014	New Zealand Bankers Association
015	Russell McVeagh
016	PricewaterhouseCoopers
017	Ernst & Young Limited
018	New Zealand Law Society
019	Baucher Consulting Limited
020	Chapman Tripp (paper submitted to the New Zealand Law Journal)

From: Hoogenboom Family [redacted]
Sent: Thursday, 8 September 2016 14:36
To: Policy Webmaster
Subject: Hybrid mismatch arrangements

Dear Sir/Madame,

A system could be set up where on the yearly basis the amount of GST a company has to pay is set inversely proportional to the amount of local tax this company pays.

With regards

JJL Hoogenboom
[redacted]

125 Creswick Terrace
Wellington 6012

Deputy Commissioner, Policy
Inland Revenue
P O Box 2198
Wellington

Addressing hybrid mismatch arrangements

Dear David,

I wish to make a submission in support of the recent release by the Government of the discussion document seeking to counter tax mismatches through the use of hybrid arrangements.

I support the government's moves in this area as the tax reductions possible through their use are, by definition, only available to companies that transact cross-border. As New Zealand's tax policy is heavily guided by a desire to improve efficiency through removing distortions it is the correct thing to do to ensure cross-border activity is not incentivised compared to domestic activity.

It also has fairness or equity benefits because such tax reductions are not available to New Zealand firms operating only in New Zealand.

I wish to commend the policy officials for their work on this paper as - even for tax - it is a technically complex area.

I do, however, wish to make two specific points.

First while I welcome the comprehensiveness of the proposals I am aware that there is significant concern in the tax community about the complexity - particularly in respect of imported mismatches. I am also aware that within its BEPS programme the government still needs to address excess interest limitations and the limitations of the transfer pricing and permanent establishment rules.

With this in mind, if pushing through comprehensive rules creates such an antagonistic environment with the private sector that the other issues would struggle to proceed - I would prefer a less comprehensive approach. From the recent labour hire firm proposals to the staged approach to the 2009 international tax reforms to the limitation of the acting together rule to thin capitalisation and some NRWT structures - a less than comprehensive approach to tax reform is quite usual.

Secondly - as alluded to in paragraph 7.29 - I cannot see any reason why these rules would not apply to trusts with a resident trustee and non-resident settlors - foreign trusts. To the extent that the settlors do not face taxation on any income earned by the trustee this exactly creates the double non-taxation that these proposals are seeking to address. To otherwise exclude foreign trusts from these proposals would only make sense in terms of an unprincipled concession to the foreign trust industry.

I would be happy to discuss either of these points with officials if that would be helpful. I can be contacted on andreataxandyoga@gmail.com.

Andrea Black
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28 October 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLNGTON 6140

Dear David

Re: Addressing hybrid mismatch arrangements – a Government discussion document ("the DD")

This is a submission on the above Discussion Document.

Submission 1 Foreign trusts should not be reviewed as part of the review of hybrid instruments

As you are aware the Government established in April 2016 an Inquiry under section 69(3) of the Inquiries Act 2013 constituting one person, Mr John Shewan. The Shewan Inquiry sought and received submissions on its terms of reference which were broad and policy in nature. The Inquiry reported in June 2016 with detailed recommendations which concluded that New Zealand should retain its existing tax laws relating to foreign trusts but ensure adequate information disclosure.

The Government accepted those recommendations. Our first submission is that there should be no additional changes to the tax regime for foreign trusts given the Government's acceptance of the Shewan Inquiry's findings. Should the Government now wish to revisit this, there should be a detailed analysis of the Shewan Inquiry and which changes should be made that are inconsistent with that Inquiry.

Para 7.29 of the DD

Paragraph 7.29 of the DD states the following:

> There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New

> Zealand's right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.

Recommendation 5.2 of the OECD 2015 Final Report "Neutralising the Effects of Hybrid Mismatch Arrangements" (the OECD report") states:

> A reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.

A reverse hybrid is defined in recommendation 4 of the OECD report and provides:

> A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction.

Submission 2 A foreign trust is not a reverse hybrid

A reverse hybrid is defined in recommendation 4 as stated above. A foreign trust is not transparent for New Zealand tax purposes. Under New Zealand tax legislation, a foreign trust is exempt from New Zealand tax on foreign sourced income. First, this is not transparent, it is not a flow through vehicle. Second, a foreign trust is taxed on New Zealand sourced income. It is not uncommon that a foreign trust has New Zealand sourced income and therefore it has New Zealand tax liabilities. This is clearly not transparent.

Paragraph 7.29 above states that "the trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand's right to tax". As noted immediately above, this is wrong. A foreign trust has both exempt income and taxable income, namely exempt foreign income and taxable New Zealand income. This is not uncommon as many New Zealand entities have both exempt income and taxable income, clearly they should not be considered to be transparent simply due to having exempt income.

For example, New Zealand corporates have exempt income being most dividends received from foreign companies. If a foreign trust is a reverse hybrid, applying the same logic, all New Zealand corporates should also be treated as a reverse hybrid, clearly such an outcome is wrong.

Where a foreign trust earns New Zealand source income, the trustees are taxed on that income.

Given the above, no changes should be made to the existing tax treatment of foreign trusts in New Zealand. The following submissions points are made for completeness as we do not believe a New Zealand foreign trust is a reverse hybrid.

Submission 3 Settlor being part of a control group

As stated in paragraph 7.29, the reverse hybrid rules would only apply where the settlor is in the same control group as the trust. We also note that example 11.1 of the OECD report states the following (emphasis added):

> As settlor of the trust, A has the sole right, under the terms of the trust deed, to appoint trustees, which is **one of the enumerated voting rights** described in the related party rules. The fact that the constitutional documents (in this case the trust deed) do not give A the power to authorise distributions or alter the terms of the trust, **does not affect the conclusion that A holds 100% of the voting interests in the trust**.

Voting rights is defined as (recommendation 12 of the OECD report)

> Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.

As an initial comment we cannot see how having the right to appoint trustees give voting rights in a trust, let alone how any conclusion can be made that that should be 100% of the voting interests. The above OCED comments are not consistent and demonstrate the issues with this. That is, the voting rights refer to the ability to participate in any decision making concerning a distribution, yet example 11.1 states that with the settlor not having any power to authorise distributions does not affect the conclusion that the settlor holds 100% of the voting interests. Clearly, the trustee(s) has (have) the power to make distributions, and hence it is impossible to conclude that someone who has no such power has 100% of the voting interests.

Further complexities will obviously arise where there more than one settlor or where a/the settlor is deceased. For these reasons we cannot see any viable method of applying the control test to most trusts. While we do not believe trusts are transparent, if they were, we can see no basis for concluding that the trust and settlor are in the same control group and therefore conclude that it is not possible to apply the reverse hybrid rules.

Submission 4 – Applying reverse hybrid based on settlor home country tax jurisdiction rules

The DD concludes "if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person".

It certainly does not seem logical to tax trustee income if the settlor is not taxed. The settlor may have no beneficial interest in the trust, hence the tax treatment of the settlor seems irrelevant. For example, there will be situations where settlors are deceased. Presumably they are not then taxed. This should not result in the trustee being taxed.

On the face of it, it seems more logical to consider the tax treatment of the beneficiaries as they will ultimately be the taxpayers who will be taxed should any such amounts be taxed. That then raises the issue of which beneficiary? Most foreign trusts will have a number of beneficiaries, most of whom may be discretionary, and many will not know they are beneficiaries. Some beneficiaries will be charitable and therefore exempt from tax.

We conclude that it is simply not possible to tax trustees based on what the tax treatment is of the settlor or/and beneficiaries.

Submission 5 Basis of taxation

The DD by implication seems to conclude that given, the tax treatment of New Zealand foreign trusts, they are reverse hybrid instruments. For the reasons noted above, we do not believe this is correct.

- Foreign trusts will not be hybrid entities if the country that the settlor/beneficiaries reside in is a country which does not tax foreign income (regardless of the nature of the New Zealand foreign trust).
- Foreign trusts that hold equity instruments in foreign operating companies are unlikely to give rise to any tax even if the settlor or beneficiary held those shares directly.
- Many foreign trusts do not earn income (profits are simply derived by companies whose shares are held by the foreign trust), when these companies pay dividends to the foreign trust, the foreign trust may make distributions. Many jurisdictions will tax such distributions. It is difficult to conclude why the foreign trust should be seen as a reverse hybrid in such circumstances.
- Applying New Zealand tax legislation could result in the trustee having NZ taxable income (say under the FDR regime) whereas there is no foreign tax under this basis (i.e. FDR regime) to the beneficiaries or settlor, they are likely to be taxed (if there is taxation) simply on distributions. This is not a reverse hybrid.
- A foreign trust that derives New Zealand source income will be taxable on that income in New Zealand.

Submission 6 Compliance costs

The compliance costs of determining whether the reverse hybrid rules apply are likely to be substantial and in most cases no tax will be payable. We refer to the Shewan Inquiry which concluded that our tax settings are appropriate however improvements should be made to the disclosure regime. We concur with that conclusion and note that this is being progressed by the government. We see no benefit in now applying the reverse hybrid rules, noting that we do not think they should apply in any event.

Conclusion

The proposals in the DD affecting trusts are very unclear to the extent that it is not possible to provide useful detailed technical issues. Our fundamental point is that the New Zealand tax treatment of trusts is to treat them as opaque entities (not transparent entities). On that basis

they should not be hybrid instruments and should be outside the ambit of this review which should be limited to its subject matter – hybrid entities and instruments.

We note a wider concern which is that the DD seems to be extending the ambit of the hybrid review beyond the already very wide ambit adopted by the OECD. This is reflected in paragraph 7.29 with respect to foreign trusts. The OECD report is explicitly limited to what it describes as deductible/ non-income mismatches in the tax treatment of financial instruments (defined as debt, equity or derivatives of debt and/or equity instruments) and to payments under financial transactions. Thus paragraph 11 states:

> The hybrid mismatch rules focus on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated Action 2 [the hybrids project].

Paragraph 12 notes that mismatches in tax treatment that are attributable to differences in the measurement of the value of payments rather than the character of the payment, can "generally be ignored for the purposes of the hybrid mismatch rules". An example given is where one country provides a deduction for foreign exchange fluctuations but the other country does not tax such income.

Example 1.25 gives the example of a lease treated as a finance lease by the lessor (with taxable income only to the extent of deemed interest) and as an operating lease by the lessee (with deductions for all the payments). The conclusion reached is that the hybrid mismatch rules should not apply to such an arrangement because the country treating the instrument as a financial instrument taxes all the deemed interest as income. This is the case even though the lessee obtains deductions exceeding the interest income taxed to the lessor.

It is clear from the above that the OECD report does no intend the hybrid rules to operate so as to tax income or limit deductions just because an entity is tax exempt or exempt on part of its income. It accepts that an entity may get a deduction for equity (deemed interest) that may not be taxable in the hands of an offshore owner. The equity deduction may offset tax on foreign income the entity derives from another party for whom the payment is tax deductible. The report seems to accept that this does not give rise to a tax mismatch that hybrid rules should target. The report notes that a lease may be treated as a finance lease in one country and an operating lease in another giving rise to deductions that exceed the amount returned by the lessor as income but the hybrid rules will not prevent this.

In other words the OECD report is sensibly not attempting to use the hybrid rules to force the harmonisation of the tax rules of every country in the world. The OECD report recognises that the hybrid rules will not prevent international transactions that can result in lower overall tax than might be the case if all transactions were limited to one tax jurisdiction.

In contrast to the OECD positon the DD, at least with respect to its comments on foreign trusts in paragraph 7.29, seems to suggest that the hybrid rules should be used to, in effect,

remove any tax exemptions that New Zealand might apply or any New Zealand tax law that might produce an outcome different to that which would apply if the laws of some other country applied. The suggestions in the DD would even subject to New Zealand tax the income of a trust when the country of the settlor and beneficiary would not tax such income and where the country of source does not tax the income. In other words the OECD hybrid report seems to be advanced to support New Zealand tax applying when no tax would ever arise apart from the existence of a New Zealand resident trustee. We see no basis justifying this approach in terms of either New Zealand's interests or the OECD report.

We are happy to discuss our submission.

Yours faithfully
Olivershaw Limited

Robin Oliver MNZM
Director

Mike Shaw CA
Director

CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

28 October 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue
Wellington 6140

Dear David

Addressing hybrid mismatch arrangements

Thank you for the opportunity to comment on the Government discussion document, *Addressing hybrid mismatch arrangements*. We are grateful for the original ten day extension to the deadline for submissions which was notified to us (but please note our comments below in respect of process and timeframe more generally).

We appreciate the Government's desire to address base erosion and profit shifting (BEPS) that occurs via the use of hybrid entities and instruments. New Zealand is part of a globalised economy and needs to consider its policy settings in that context. We acknowledge that New Zealand needs to protect its global reputation by being a 'good global citizen' and that, as a consequence, the Government should consider the effect on other countries of New Zealand's tax policy settings and any changes to those settings.

However, we are not convinced that adopting the OECD's recommendations for addressing hybrid mismatches in the manner and timeframe envisaged is the correct approach. Rather we are concerned that adoption of the OECD's very broad recommendations as set out in the Discussion Document in the implied timeframe of the next two years or less would be to the detriment of New Zealand businesses and the New Zealand economy generally.

New Zealand's national interest

The proposals seem to be us to be inconsistent with the Government's role of protecting New Zealand's national interests and growing the New Zealand economy to maximise the welfare of New Zealanders.

New Zealand is a capital importer and is comparatively highly reliant on foreign direct investment. If the proposals were implemented in their entirety or in large measure we would be concerned that they would increase the effective tax rate on inbound investment and adversely affect New Zealand's competitiveness and productivity. New Zealand competes with many other countries for inbound investors seeking to invest in key commercial and infrastructure projects. Such projects are critical for economic development and tax policy settings must remain competitive to ensure tax does not hinder such investment or raise the cost of that investment so that it becomes infeasible.

In considering whether to adopt the OECD's hybrid recommendations the Government must be very careful to achieve the appropriate balance between doing what is good for the New Zealand economy and protecting the New Zealand tax base. New Zealand's primary focus should not be on protecting the tax bases of other countries.

Importance of other countries' responses

As noted in the discussion document, the United Kingdom and Australia have indicated their intentions to adopt the OECD's hybrid recommendations as has the European Union in respect of intra-EU arrangements. The Discussion Document does not consider the intentions of the United States, Canada, Japan, China and Singapore, for example, which are all significant sources of inbound investment into New Zealand and the home of important trading partners for many New Zealand businesses.

The indicative timeframe (draft legislation in 2017 and application from early 2018) is such that we believe there is a real risk that New Zealand could end up being a leader rather than a follower in terms of adopting the OECD's recommendations. Given that few New Zealand businesses are likely to drive decision-making within corporate groups about group structures and intra-group funding arrangements, it seems inappropriate for New Zealand to be a pioneer or one of the early adopters of the OECD's recommendations. Such decisions are driven by head offices or regional headquarters based in, for example, the United States, Australia or Singapore.

The OECD's hybrid recommendations are premised on their adoption by a number of countries. Generally in a tax context each country is free to determine its own tax policy settings i.e. national sovereignty is paramount. The hybrid proposals are therefore unusual in the sense that they result in the tax treatment in one country being determined or influenced by the tax treatment in another country. In our view the proposals will achieve the OECD's desired outcome only if they are adopted in many OECD / G20 countries if not all. On the evidence so far it seems likely that many countries, OECD member nations and others, will either not adopt the proposals or will adopt them in part only, or will be late adopters.

The risk that the OECD recommendations are not implemented widely must be factored into New Zealand's response to those recommendations. This risk should not be ignored. As Professor of International Tax Law, Juergen Luedicke, noted in his article in the Bulletin for International Taxation:

> "Why a state should pioneer the introduction of anti-hybrid rules seems to be a particularly difficult and open question since it is unrealistic that the community of states will achieve a level playing field by introducing harmonised anti hybrid rules. One may well expect at least some states to make a decision not to act if they believe that anti-hybrid rules are apt to put their own industry or inbound investments at a disadvantage."[1]

[1] Bulletin for International Taxation June / July 2014, 300

The Government needs to be cognisant of the fact that implementation of the proposals could result in New Zealand taxpayers being denied deductions because of the tax treatment that applies in another country, which may not have adopted the proposals itself.

We are not suggesting that New Zealand should not be a 'good global tax citizen'. Our concern is that New Zealand becomes a leader despite the country's small size and miniscule share of the global tax base for no other reason than to be seen to be making reforms in line with the OECD's recommendations.

The Government needs to bear in mind that the BEPS project including the hybrids recommendations have been driven by countries with significantly larger economies, which are more attractive because they have significantly larger consumer markets and pools of capital. The solutions offered are primarily designed to assist those economies. The size of those economies means that investment is likely to be 'stickier'. New Zealand's economy does not have the same attractiveness.

It is naïve to assume that New Zealand subsidiaries of multi-national companies will be able to determine or influence the tax treatment of arrangements and financial instruments and changes to that treatment in other countries.

The proposals as part of a broader framework

We welcomed the release of the draft Inbound Investment Framework and the strong signal it sent that any changes to New Zealand's tax rules in response to the OECD's BEPS action plan would be considered in the context of a broader framework that focuses on what is good for the New Zealand economy. We were pleased that the draft Framework made it clear that:

- a Government priority is to ensure that New Zealand continues to be a good place to invest;
- New Zealand's tax system has the overarching goal of maximising the welfare of New Zealanders and the Framework should be seen as part of this system;
- a balance needs to be struck between:
    - ensuring that taxes do not unduly discourage foreign investment or increase the cost of capital for New Zealand businesses, and
    - protecting New Zealand's tax base and preventing tax avoidance;
- any proposals to change current policy settings would be considered within an explicit, robust and coherent economic framework.

The Discussion Document makes no reference to the Inbound Investment Framework. This surprises us given the Framework was intended to be the guiding document against which proposals to counter BEPS in New Zealand would be measured.

Scope and complexity of proposals

The proposals in the Discussion Document are cast very broadly and seem to suggest a fundamental re-think of New Zealand's taxation of inbound and outbound investment. They have implications for many of New Zealand's taxing regimes including the rules that apply to:

- controlled foreign companies
- foreign investment funds
- branches
- thin capitalisation
- withholding taxes
- source and residence
- tax avoidance (New Zealand's general anti-avoidance rule).

The breadth of the proposals is such that they will affect a large number of taxpayers and will have implications for many ordinary business dealings, including, for example, for every taxpayer operating a foreign branch. The potential scope of the proposals is not limited to large multi-national businesses. The proposals will also affect SMEs, partnerships and individual taxpayers.

The Discussion Document does not appear to set out the proposed limits of the hybrid project. Paragraphs 4.7 and 4.8 refer briefly to some of the OECD limitations. In our view the Government should confirm upfront as an underlying principle that the scope of the project is limited to financial arrangements (equity, debt and derivatives) and payments under such instruments. It should confirm that finances leases and any tax exemptions New Zealand may provide in whole or in part are outside the scope of the project.

The proposals are also extremely complex. The Discussion Document is 83 pages and it effectively recommends the adoption of the 450 pages of OECD recommendations. In our view the breath and complexity of the proposals mean that there is a high risk of overreach and collateral damage i.e. a high risk that the proposals will affect genuine commercial transactions that are not the target of the OECD's recommendations. Overreach will create a particular problem if deductions are denied on interest cost necessarily incurred in funding New Zealand business operations.

The complexity of the proposals is such that they also risk creating real uncertainty for taxpayers. Legislative amendments to address hybrid mismatch arrangements should be drafted narrowly and as precisely as possible so that the potential for overreach and collateral damage to commercial arrangements is avoided or at least minimised as far as possible.

As Luedicke states:

> "Such countermeasures [anti-hybrid rules] should be drafted as narrowly and precisely as possible based on a proper consideration of situations which do indeed raise policy concerns. It is important to consider that any countermeasure is a deviation from the "normal" system of the tax law based on rules chosen by a sovereign legislator. These rules are generally independent of other states' laws. Countermeasures need to be drafted in a way which avoids unintended economic or juridical) double taxation. … They should not punish taxpayers for behaviour which is caused by uncoordinated or deficient legislation."[2]

There appears to be an underlying assumption that hybrid instruments are exclusively tax driven so that any overreach or collateral damage can be dismissed. We think this assumption is flawed.

Timeframe and process

A more considered approach will result in a better quality and sustainable outcome, without compromising New Zealand's ability to achieve appropriate reforms within OECD preferred timeframes. Indeed, the OECD anticipates that countries will need to move at a pace and scope commensurate with their existing tax systems and with legislative and government priorities.

In our view the Government would be better advised to take a targeted approach to addressing hybrid mismatch arrangements. By this we mean an approach whereby any amendments to New Zealand's domestic tax laws are focused specifically on the use of hybrid entities or instruments in New Zealand that the Government does not believe can be addressed by the existing law including the general anti-avoidance rule.

A more targeted approach would result in law reform that is more relevant to the New Zealand 'context'. It would also be able to take into account that New Zealand already has robust primary rules including the denial of foreign dividend exemptions for deductible dividends and a powerful and judicially supported general ant-avoidance rule.

A more considered approach would also ensure New Zealand does not become an early adopter or a leader in this context. We understand that Australia has yet to release draft legislation for consultation or introduce a Bill and is unlikely to do so until next year (which, given the Parliamentary process and the Board of Taxation's recommendation of an application date 6 months after enactment, would suggest a 2019 application date). As a significant portion of New Zealand's inbound investment is sourced from Australia, it would seem sensible for the Government to wait until Australia's legislation has been introduced. This would allow the New Zealand legislation to be aligned with Australia's rules where appropriate.

[2] Ibid, 310

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Part II

Part II of the Discussion Document poses twenty nine questions, almost all of which are open ended. For example:

- 5B “are there any issues with the proposed approach in applying the secondary rule to hybrid dividends?”
- 5D “will this approach to CFC inclusion give rise to any practical difficulties?”
- 5H “are there any issues with providing no exclusion for regulatory capital?”
- 6D “is it appropriate to depart from the OECD’s recommendations in relation to CFC income as dual inclusion income?”
- 9A “are there any issues that may arise in relation to the implementation of Recommendation 7 (dual resident payers) in New Zealand?”

This approach effectively requires taxpayers to anticipate and suggest solutions to any issues arising from the proposals. In our view this analysis should be undertaken by Officials.

A more effective approach would be for the Government, first, to clearly articulate the policy rationale for, and the scope of, the project; secondly, to release more detailed targeted proposals; and, thirdly, to prepare, release and consult on draft legislation. Such an approach would allow the private sector to respond to specific proposals rather than to a set of broad, open-ended questions. It would also ensure that Officials have had the opportunity to turn their minds to the policy rationale for specific amendments, to the practical implications of the proposals in a specifically New Zealand context and to drafting rules that are comprehensible and fit for purpose.

We provide below some comments on Part II of the Discussion Document. In the time available and given the broad manner in which the questions in Part II are posed, our comments are necessarily of a high level only. Once Officials have undertaken further work on developing proposals that address the issues in a New Zealand context more specifically and have released draft legislation, we are likely to be in a better position to comment more fully. In the meantime the comments made below should be considered preliminary only.

Chapter 5: Hybrid financial instruments

Recommendation 2: changes to existing domestic rules

Expansion of section CW 9(2) (c)

We understand the rationale for expanding section CW 9(c) (2) to deny exemption for a dividend which gives rise to tax relief equivalent to a deduction in the payer jurisdiction.

Denial of imputation credits

It seems appropriate for the definition of "segment" to be changed so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign sourced income.

Recommendation 1: linking rules

We consider that the need for a payment deductible in New Zealand under a cross border financial arrangement to be taxed in the hands of a taxpayer of ordinary status within a reasonable period of time fails to fully recognise that hybrid mismatches are often temporary rather than permanent. Any denial of deduction should occur only when the hybrid mismatch has a permanent effect.

Differences in valuation of payments not relevant

We agree that the difference in valuation of payment is not relevant as a foreign currency loan will normally give rise to a foreign currency gain or loss in respect of the loan.

In respect of optional convertible notes in the New Zealand context we suggest that the issue has been settled.

New Zealand financial arrangement rules count foreign currency gains or losses as interest. It is proposed that only the interest component under a hybrid instrument be subject to denial of deduction. This means that any foreign currency gain or loss will need to be excluded. This will add to compliance costs and require changes to some accounting systems.

Timing differences

The Australian Board of Taxation Report has recommended a three year gap between deduction and inclusion of income and payments. Our preference is for the focus to be on permanent mismatches rather than on temporary timing mismatches between deduction and inclusion. This is particularly the case because chapter 11 proposes that withholding tax should continue to apply. This will create double taxation of the same income. It is inconsistent with New Zealand's approach to the taxation of equity income.

A three year approach, as suggested by the Board of Taxation, may be an acceptable compromise to ensure that shorter timing mismatches are not subject to complex rules. A commercial test, where the loan terms match expected cash-flows, should also be available.

We support the Board of Taxation's carry-forward proposal so double taxation does not occur. We also believe consideration should be given to the UK approach of reasonable, consequential adjustments (carry back adjustments).
There also needs to be the ability to allow for correction of treatments as countries' time frames for implementation of the hybrids recommendations will vary, with some countries unlikely to adopt any or very few of the proposals and others likely to defer adoption for some years.

Taxation under other countries' CFC rules

It is likely to be difficult for New Zealand corporates to establish that a payment is subject to tax in the hands of the payee's owner under a CFC regime. New Zealand entities are often at the 'bottom' of corporate structures and, in many cases, payments made by or to New Zealand corporates will be immaterial to the group's overall position. They will often be unfamiliar with the tax treatments prevailing in the jurisdictions in which other members of the group are located.

However, given the target is D/NI income, if a CFC regime overturns that result, the hybrid rules should not apply. In the absence of a CFC exclusion, the result of the hybrid rules applying would be an ND/T double taxation result.

We are comfortable that the existing onus on taxpayers would mean that only taxpayers who have appropriate systems or material amounts would be able to use this exclusion. The expected difficulty in complying should not prevent those who can comply from benefitting from a principled rule.

Proportion of purchase price treated as payment under a financial arrangement

There is no principled justification for this proposal.

Hybrid transfers

We agree that there should be rules to address share loans or share repos (where the transferor and transferee are both treated as the owner of a financial instrument) that give rise to a hybrid mismatch.

Substitute payment

We agree that, if a substitute payment gives rise to a hybrid mismatch, the hybrid rules should apply subject to any timing rules.

Regulatory capital

Further detailed consideration needs to be given to whether New Zealand should exclude regulatory capital from any hybrid rules it implements. The Australian Board of Taxation highlighted the complexities and interactions involved and recommended further work be undertaken on the issues.

Applying the secondary rule to hybrid dividends

We understand the Government's reasoning for applying the secondary rule to hybrid dividends.

Timing mismatches

We understand the desirability of matching the Australian approach to removing any timing advantages should New Zealand not adopt the same deferral period. This will also depend on the carry back or forward treatments introduced.

Effect of CFC inclusion on application of Recommendation 1

We predict practical difficulties arising where multiple countries are involved with some having hybrid rules and others having no rules or limited rules. Taxpayers will have to bear significant compliance costs.

Taxation of FIF interests

We recommend that FIF interests are excluded from any hybrid rules. Although any rules may only affect FIFs with ownership between 25 and 40 percent (see our comments regarding structured arrangements), the exclusion of dividend income is in effect part of the income calculation. The FDR, cost and DRR methods are proxies for income from a share that in the classic sense is a dividend.

Transfer of assets: revenue account holders

We agree that revenue account holders should be exempt from the rules.

Transfer of assets: hybrid transfers

The recommendation to amend the income tax treatment of New Zealand residents who hold shares subject to a hybrid transfer appears to be a practical response given New Zealand's current rules.

Other exclusions

We consider it desirable that New Zealand gives an exemption to any hybrid rules to which a financial trader is a party. This would be consistent with the UK and Australian proposals.

Applying within New Zealand

We see no policy rationale for applying any hybrid rules to arrangements within New Zealand.

Chapter 6: Disregarded hybrid payments

We are concerned at the uncertainty likely to arise in this area. As noted at paragraph 6.7 of the Discussion Document the question of whether an entity is a hybrid payer will not turn on a preordained list of entities and no characteristics in and of themselves would qualify an entity as a hybrid payer. An entity that is considered a hybrid payer in one scenario may not be a hybrid payer under a different scenario. In our view caution is required before such a broad-brush recommendation is implemented.

Applying carry forward loss rules to carry forward of disallowed deductions

We agree that denied deductions should be able to be carried forward. Applying the current carry forward loss rules to the carrying forward of disallowed deductions is less clearly justified. The effect of the denial is either to treat the deduction as not incurred at that point or as a matching rule with the future income. The principled result seems to be to consider whether there is any net income. As there is not, no taxation should arise.

Dual inclusion income

A simple dual inclusion income approach would be needed to avoid unnecessary complexity and excessive compliance costs.

Carry forward / reversal of defensive rule income

Given the potential for over-taxation in the absence of a carry-forward rule for the application of the defensive rule, we believe it is appropriate to depart from the OECD's recommendations. A reversal rule whereby the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income seems easier to apply than a limitation of the defensive rule.

CFC income as dual inclusion income

Excluding CFC income from dual inclusion income seems appropriate given the likely infrequency of situations in which inclusion is required and the likely complexity of rules to address the issues. However, we note the likely double taxation effect. The ability to exclude CFC income should therefore be considered (in the knowledge that not all taxpayers who might benefit would incur the costs of compliance).

Chapter 7: Reverse hybrids

Recommendation 4

One of the difficulties with Recommendation 4 is that a taxpayer making the payment will require detailed knowledge of the tax treatment of the payment in the hands of the payee. This is likely to be more difficult for extended control groups (beyond parent-subsidiary relationships). In addition, to administer these rules, Inland Revenue will need to have a complete understanding of the tax treatment of each payment in each jurisdiction. This seems unlikely.

Recommendation 5.1: CFC rules

We do not believe it is in New Zealand's interest to amend its CFC rules. New Zealand's CFC rules are robust and already meet OECD's best practice. Furthermore, our CFC rules were amended in 2009 to reduce barriers faced by New Zealand companies and encourage businesses with international operations to remain in, establish or expand their offshore activities.

The current CFC rules are extremely complex and impose a compliance and administrative burden on taxpayers. Further amendments to the CFC regime, to impose New Zealand tax on income allocated to a New Zealand resident by a reverse hybrid, will increase the complexity of the rules and the compliance and administrative burden. For some CFCs, financial information may not be available. This could occur when the taxpayer does not control the CFC.

These proposals could inhibit the retention or establishment of New Zealand based multi-national businesses. We note that the Australian Board of Taxation's March 2016 report to the Australian Treasurer recommends that OECD Recommendation 5 not be implemented immediately but that it be left open to implement in the future if integrity concerns arise and after the merits have been given further analysis.

Reverse hybrid entities established in New Zealand

Foreign trusts

First, we do not believe New Zealand foreign trusts should be treated as reverse hybrid entities. Foreign income derived by foreign trusts is exempt, New Zealand foreign trusts are taxed on New Zealand sourced income only. New Zealand taxes trusts (including foreign trusts) as opaque entities. For example, where a foreign trust derives New Zealand source income, the trustee is taxable (not the beneficiaries or settlor). If income is allocated to beneficiaries, the tax liability is on the beneficiaries but that is equivalent to a deduction outside the scope of the hybrid proposals, as per the Discussion Document's own reference (at para 4.7) to the OECD report. If that were not the case, co-operatives would be reverse hybrids. For these reasons alone, foreign trusts should not be classified as reverse hybrid

entities. The fact that New Zealand provides an exemption for the foreign sourced income of foreign trusts is not relevant. The OECD report is clear that the fact that a country provides tax exemptions does not create hybrid mismatches that should be subject to these rules.

In our view it is inappropriate for New Zealand to tax foreign sourced trustee income. The income has no connection with New Zealand apart from the existence of a trustee in New Zealand who has no beneficial interest in the income. New Zealand's current trust regime was established in 1988 and is based on the international model that taxes residents on their worldwide income and non-residents on local income derived from that country. Under this model, non-residents are deliberately not subject to New Zealand tax on their foreign sourced income. The Shewan Inquiry reviewed this outcome and concluded the current tax treatment was appropriate. Applying Recommendation 5.2 to tax trustee income, if it is not taxed to the settlor (assuming a settlor is alive and/or exists) or any other person is unprincipled and changes a fundamental aspect of New Zealand's tax policy settings. From a New Zealand perspective, there has been no erosion of the tax base.

New Zealand branches

It is not clear that New Zealand should implement a rule that would have the effect of taxing income, that under current New Zealand tax rules is not taxable, simply because it is treated by another jurisdiction as attributable to a New Zealand branch and not taxable in that jurisdiction.

As a small capital importing country New Zealand has to balance following the OECD's recommendation and being an attractive place for non-residents to invest.

The Discussion Document appears to fail to consider the recent amendments to the NRWT rules (narrowing of the onshore branch exemption) included in the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill. As a result of the proposed amendments interest income derived by a non-resident with a New Zealand branch will be subject to NRWT unless the money lent is used by the non-resident for the purposes of a business it carries on through its New Zealand branch. If interest income derived by a non-resident is made taxable because New Zealand implements the OECD recommendation to neutralise mismatches caused by differences in the allocation of income between the branch and head office, New Zealand's claim to tax increases to 28%. If that tax increase is passed back to a New Zealand borrower (via a gross-up clause), the New Zealand borrower will suffer an increased cost of funding.

The lack of discussion of the NRWT amendments surprises us. In considering whether to adopt the OECD hybrid recommendations, the Discussion Document should have considered the outcomes for all of the tax regimes including NRWT.

CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

Chapter 8: Deductible hybrid payments

Exemption for active income of foreign branch

If foreign branch losses are not able to be deducted against New Zealand income, there should be a matching active income exemption.

Alternatively, consideration could be given to including a provision that preserves New Zealand tax if a New Zealand corporation has deducted foreign branch losses from its worldwide income and then once it becomes profitable exchanges its branch assets for foreign corporation shares.

Chapter 9: Dual resident payers

Recommendation 7: Dual residents

In our view the Chapter 9 fails to take into account commercial realities. Paragraph 9.3 states: “However, given that dual residence status is in most cases deliberate rather than accidental, it should be possible for taxpayers to be aware of the possibility of double taxation, and by adopting simpler structures, avoid it”.

In our experience “dual residence status” is most often the inevitable result of companies operating cross border where New Zealand statute makes a company resident if either incorporated or managed or controlled from New Zealand. In a trans-Tasman context this inevitably gives rise to dual residence. If New Zealand wants to avoid dual residence of companies it should limit the breadth of our corporate residence test – not punish those who are dual resident as a result of it. As the law now stands a New Zealand incorporated company can unintentionally become a dual resident when New Zealand directors, who manage and control the company, emigrate.

Practical difficulties will arise in identifying dual inclusion income where income is recognised at a later point in time.

Excess amounts disallowed should be able to be carried forward to set off against dual inclusion income in another period.

DTA dual resident rule

Before implementing such a rule, the implications of treating a New Zealand entity as a non-resident need to be fully considered. The effect on New Zealand’s revenue base must be considered. The rule would mean that **all** foreign sourced income derived by a non-resident under a DTA tie-breaker test that breaks the residence to the other country would not be subject to New Zealand tax under New Zealand domestic law. Furthermore, non-resident passive income could be subject to a lower rate of New Zealand tax.

Chapter 10: Imported mismatches

Recommendation 8: Imported mismatch rule

We consider that the imported mismatch rule will impose a significant compliance burden on New Zealand taxpayers (and also on Inland Revenue). As acknowledged at paragraph 10.5 the imported mismatch rule will be complex to apply and will require knowledge of the tax consequences of a wide range of transactions within a group. We strongly disagree that the necessary information will be readily available if a group is structured in a straightforward way and monitors the existence of hybrid mismatches intra-group transactions. Given that most of our major trading partners have not implemented these rules it is unlikely that groups will be monitoring the existence of hybrid mismatches on all intra group transactions.

The imported mismatch rule can apply where a New Zealand borrower makes a payment under a (vanilla) loan, and under another arrangement in the series there is a relevant mismatch which is not counteracted by foreign equivalent provisions.

New Zealand taxpayers will be expected to follow funding arrangements and work out that a mismatch arises in arrangements between third countries. Difficulties in tracing and apportionment are likely. The source and application of funds is not always clear. Taxpayers will need to keep abreast of any law changes in those foreign countries that may change the New Zealand tax treatment. To administer these rules Inland Revenue will need a complete understanding of the respective tax treatment for each entity in a wider chain of entities involved, including aspects that otherwise have no direct effects or consequences from a New Zealand revenue perspective. Based on the OECD recommendations, the imported mismatch rule contains design thresholds which will make the rule extremely difficult to comply with and administer.

Importantly, the imported mismatch rule will breach a fundamental tax policy design principle, namely that the policy is workable for taxpayers and compliance costs are kept to a minimum[3].

Further, the fact that this recommendation is being considered undermines the case for adopting the OECD recommendations. Part 1 concludes that global implementation will likely benefit New Zealand. Recommendation 8 assumes the hybrid rules have not been adopted.

CA ANZ strongly recommends that Recommendation 8 is not implemented until a majority of other OECD countries have implemented their own hybrid mismatch rules. If New Zealand implements the hybrid mismatch rule ahead of its trading partners, an unfair compliance burden will fall on New Zealand taxpayers.

[3] Recommendation 9 1(h)

Chapter 11: Design principles, introduction and transitional rules

Design principles

At this early stage of proposal development we believe that what is likely to be required is a balance of principles-based drafting, which sets out the policy underpinning the rules, and more precise and prescriptive drafting for issues that require clear boundaries and the provision of certainty to taxpayers. In the absence of more definitive proposals, including draft legislation, it is however, difficult to form a view.

Date of introduction

In our view New Zealand should defer the introduction of anti-hybrid rules until the approach to be adopted in the majority of other OECD and G20 countries is much clearer. Australia and the United Kingdom have progressed further than other OECD / G20 countries but it is important to see how the United States, Canada, Singapore, Japan and other sources of inbound investment also respond. New Zealand should not get ahead of other countries and particularly Australia which we understand has introduced but not enacted legislation.

We note that the Board of Taxation in Australia has recommended that the rules should commence in Australia for payments made on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives the Royal assent. At a minimum New Zealand should not contemplate an effective date until after the Australian legislation has become effective.

Grand-parenting

Existing arrangements have been put in place on the basis of the current rules. Applying very complex new rules to existing arrangements seems unfair and likely to impose high compliance costs. On that basis we suggest arrangements existing at the date of introduction of the new rules in a Bill should be grand-parented. If existing arrangements are not grand-parented New Zealand taxpayers will have to bear the costs of unwinding or restructuring existing arrangements (break costs, advisor fees, foreign exchange adjustments) and the additional funding costs of replacing the arrangements.

We note that the Australian Board of Taxation has not recommended grand-parenting as a general rule but has suggested that, as the legislation is developed, there may be certain categories of arrangements that are identified as appropriate for grand-parenting. This approach seems to leave significant scope for uncertainty but may be fairer as it allows scope for appropriate grand-parenting.

Transitional rules

Given the extremely complex nature of the proposals, and the likelihood that the draft legislation could undergo significant change as it goes through Parliament, transitional rules should be introduced. Again the Australian Board of Taxation did not recommend transitional rules generally but noted that during the legislative design process "it may be identified that particular categories of arrangements require transitional rules" – again an approach that could lead to uncertainty but may be helpful from a fairness perspective.

De minimis rules

In our view de minimis rules can be useful if they minimise the compliance costs imposed on taxpayers. If, however, such rules require taxpayers to undertake complex calculations and analysis to determine whether they can be relied upon, they cease to be useful.

The inclusion of a de minimis rule is likely to be particularly important in the context of the imported mismatch rule, which requires taxpayers to be aware of the tax treatment of different entities and instruments in multiple jurisdictions.

Withholding tax

In our view imposing withholding tax while denying a deduction for a payment would be inequitable. Such an approach would increase the cost of capital if there is a gross up clause, which will generally be the case

Chapter 12: Key definitions

All definitions will need to be clear and unequivocal.

Structured arrangement

Paragraph 12.7 proposes to amend New Zealand legislation and include a definition of "structured arrangement". However, we note that paragraph 12.6, which is integral to the definition of "structured arrangement", will not be incorporated into New Zealand legislation. Paragraph 12.6 sets out the facts and circumstances which should be taken into account in determining whether or not an arrangement has been designed to produce a hybrid mismatch. On its own, paragraph 12.7 is capable of wide application to common investments. (See the FIF paragraphs at 5.41 which raise that possibility.)

We refer to Professor Luedicke's view quoted at page 4. The anti-hybrid rules should be drafted narrowly and precisely. The proposed definition at 12.7 is neither narrow nor precise.

We recommend that paragraph 12.6 be incorporated into New Zealand legislation.

We are happy to discuss our submissions with you. If you have any questions please contact Teri Welham, Stephen Rutherford or me.

Yours sincerely

Peter Vial
Tax New Zealand Leader

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Addressing Hybrid Mismatches
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3 November 2016

Dear Sir/Madam

We welcome the opportunity to respond to the *Addressing Hybrid Mismatches – A Government Discussion Document* ("the DD"). We also appreciate the ability for ongoing constructive dialogue with Officials on this complex area.

Adopting a global programme for New Zealand

We understand and appreciate that the BEPS programme is a global programme. It relies on global implementation. However, the Action 2 recommendations raises the need to balance two competing perspectives.

- Embracing the OECD's recommendations will align New Zealand with some other countries and meet perceived community expectations. This will make New Zealand a good global citizen with a fair tax system.
- Rejecting the OECD recommendations will retain the coherence and sovereignty of New Zealand's tax system and maximise foreign investment in New Zealand.

Both perspectives need to be considered against the fiscal impact of the proposals.

The DD concludes that a comprehensive approach will likely be in New Zealand's national interest. We are not convinced that the case has been sufficiently robustly made. We consider that the DD over-estimates the revenue at risk from failing to adopt the recommendations and the revenue that will be collected as a result of adopting the rules.

We acknowledge that it is possible to reasonably disagree on the balance between the competing perspectives. However, much of what is proposed in the document goes too far, too fast.

We consider that New Zealand should proceed with caution. It should adopt measures clearly in New Zealand's overall interests. This is not to say that there is no need for reform but it should be selective. It should seek to protect existing rules which make sense for New Zealand's tax system. Otherwise, it risks incoherence and reduced revenue and investment.

New Zealand's tax system

New Zealand's tax policy generally follows a principled approach. The Tax Working Group's conclusion that New Zealand's tax system is generally coherent and works well is correct. Disagreements on where the relevant boundaries should be drawn does not change that

conclusion. As they are subject to on-going consultation and review, they are evidence of the good health of the tax system generally.

Generally, New Zealand's tax system:

- Draws the boundary between debt and equity and opaque and transparent entities on a thought out, principled basis;
- Considers company tax as a withholding tax (although that is sometimes conveniently ignored in cross-border scenarios) given the imputation regime;
- Aligns tax rates and systems so that double taxation is minimised;
- Applies a broad based consumption tax; and
- Does not seek to advantage or disadvantage particular behaviours or investments.

Comparing New Zealand with the OECD's programme

Implementation of the BEPS recommendations needs to be carefully considered. The proposals need to be evaluated on a principled basis which is consistent with New Zealand's tax regime. A "New Zealand should adopt it because the OECD has recommended it" approach is not sufficient justification for proceeding and certainly not at speed.

This is particularly the case because the OECD recommendations can be best described as pragmatic. A principled approach would recommend clear debt/equity and opaque/transparent entity borders. It would also limit the potential for double taxation rather than encouraging it.

The OECD recommendations do not specifically take a principled approach. As the DD acknowledges, that is not possible. Instead it recommends tax rules which produce de facto borders and allow double taxation.

Applying the recommendations therefore risks generating incoherent outcomes for the tax system.

The risk factors

This risk is in our view compounded by a number of factors.

Are some of the results in the DD really a hybrid mismatch concern?

The proposals are wide ranging. They question fundamental outcomes of regimes which have been tested through the full generic tax policy process. These regimes achieve what New Zealand wants them to achieve. These are deliberate outcomes.

The proposals will change those outcomes because of decisions made, and not made, by other countries. In some cases with the only apparent justification that the OECD has recommended the rules.

In our view, the results of New Zealand's regimes are defendable from an anti-hybrid mismatch perspective. For example, see the characterisation of the FITC regime referenced in a DD footnote. This shows it is possible to analyse regimes to show they do not provide a hybrid mismatch result. The DD does not appear to do this analysis for any other regimes. New Zealand should consider how its regimes are properly characterised to confirm a hybrid mismatch result and the need for action.

The fiscal impact of the proposals – positive for New Zealand?

The policy justification (in Part 1 of the DD) is that a globally consistent implementation of the proposals will even the global playing field for investment. New Zealand will benefit from a reduced global incentive to use hybrid mismatches. The analysis and justification is brief and qualified. It is focused on "greenfield" investment. It does not appear to consider potential downstream impacts. The net benefits for New Zealand are therefore uncertain.

The analysis assumes the proposals will be neutral or positive for New Zealand's fiscal position. Hybrid arrangements are assumed to be replaced by equity capital, rather than debt. This assumption needs to be tested, particularly as use of replacement debt may be at higher interest rates.

Cost of capital and compliance costs

New Zealand will generally deny deductions for inbound hybrid financing under the proposals. This will impose additional costs on domestic factors. This includes the substantive loss of tax deductions. It will also require evaluating whether a funding arrangement gives rise to a hybrid mismatch outcome. This will require knowledge of how other countries will tax the arrangement. The compliance costs on borrowers and investors, due to the wide "structured arrangement" definition proposed, should not be underestimated. This is a practical issue.

Other countries' implementation and approach matters to New Zealand's position

Most other countries' tax regimes seek to achieve trade, jobs and fiscal revenue objectives. The BEPS project received political support as, globally, Government revenues were under pressure following the global financial crisis. However, this does not remove the trade and jobs objectives of other countries' tax regimes.   Individual countries will continue to make choices for those, and not just pure tax policy, reasons.

For example, refer the United Kingdom, which has introduced hybrid mismatch rules but at the same time a concessionary "patent box" tax regime to attract technology businesses. The US appears unlikely to adopt any BEPS proposals it considers will adversely impact its multinationals operating globally. (The US Treasury response to the European Commission State Aid Ruling against Ireland is potentially illustrative of its likely position.)

We therefore expect implementation to be inconsistent and ad hoc, based on political economy. Not all major economies will follow suit.

The DD focuses on Australia, the UK and in part the EU. The DD does not explore the reasons why these countries have decided to progress with implementation. Our expectation, based on publically available information, is they have decided that the hybrid mismatch rules are fiscally positive for them. This suggests fiscal self-interest rather than global co-ordination providing welfare benefits is the driver.

Even for those countries which the DD considers will implement the rules, the DD does not draw the conclusion that New Zealand's adoption of the rules may be moot. In our view, the New Zealand fiscal position from implementing the rules is much less clear. In fact, our expectation is that the rules may negatively impact the fiscal position.

The DD ignores the position of major investing and trading partners for New Zealand. It therefore does not present a complete picture.

The impact on commercial arrangements

We understand the expectation is that implementation of the proposals will mean there are no hybrid mismatches. The proposals are prophylactic. That may be the case for intra-group structured arrangements which are perceived to have little substance. However, those arrangements appear to already be dealt with by New Zealand's tax system.

Further, the proposals go beyond such related party arrangements. The DD appears to target every possible mismatch, without properly considering whether a hybrid response is justified. We note specifically the sections which deal with FIF mis-matches as an example. Implementation will therefore affect commercial arrangements.

Full consideration of the consequences cannot be done in the time allowed

Finally, the time allowed for consideration has been insufficient to fully and coherently consider the impact of the proposals. The proposals question the outcomes for many and varied New Zealand tax regimes. In our view, the justification for many of the proposals is lacking.

Further, the flow on consequences do not appear to have been fully considered. For example:

- Is the FIF regime sustainable if the FIF regime is considered to produce hybrid results?
- Will the hybrid rules adversely affect the application of New Zealand's General Anti-Avoidance Rule?
- How do the recommendations overlap so that they can be simplified?
- What opportunities are there to improve New Zealand's rules if the recommendations are implemented?

There is a real sense that this is too far too fast.

Principal recommendation: a phased approach is supported

A better approach would be to consider discrete parts of the Action 2 recommendations by identifying the hybrid arrangements that are most pressing for New Zealand's tax base. This would allow:

- more time to consider the impact and implementation of the remaining recommendations;
- New Zealand to better assess the prospects for other countries to implement the recommendations and therefore the need to implement complex rules with wide application and uncertain effect.

Our recommendation is therefore for a phased approach.

Approach to detailed submissions

These general comments and submissions underlie our detailed comments and observations.

Given the very short timeframe, the breadth of the proposals and uncertainty as to their impact, we have taken the approach of providing detailed comments and responses directly on a word version of the DD. (They are identified by *underlining and labelling as* ***KPMG Comment***.)

We have left the detailed comment section of our submission in draft. This recognises the complexity of the proposals – we may have misunderstood what is being proposed.

We acknowledge the comments may not present a coherent response across the range of recommendations. That is a function of the time available, the range of issues and uncertainty as to what is being proposed and its impact in some cases. Our recommended phased approach will provide a better opportunity to provide a more coherent response.

We trust that our approach encourages continued discussion and makes it easier to match the submission to the proposal.

We would be pleased to discuss our submissions. Please contact John on 04 816 4518.

Yours sincerely

John Cantin
Partner

Yours sincerely

Darshana Elwela
National Tax Director

Addressing hybrid mismatch arrangements

A Government discussion document

<u>KPMG Comment and Observations</u>

3rd November 2016

Hon Bill English
Minister of Finance

Hon Michael Woodhouse
Minister of Revenue

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CONTENTS

Introduction

Hybrid mismatch arrangements are one of the main base erosion and profit shifting (BEPS) strategies used by some large multinational companies to pay little or no tax anywhere in the world. As such, the OECD has developed recommendations for anti-hybrid measures in its 15 point Base Erosion and Profit Shifting (BEPS) Action Plan.

Hybrid mismatch arrangements exploit the different ways that jurisdictions treat financial instruments and entities to create tax advantages. Because countries have different tax systems, misalignment of domestic rules is inevitable. The OECD recommendations attempt to prevent this misalignment from giving rise to unintended tax advantages. This is primarily done through the use of "linking rules" which change the usual tax treatment of cross-border transactions to ensure that there is no hybrid mismatch in such cases.

Since hybrid mismatch arrangements are not necessarily artificial or contrived, the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches. To achieve this, the proposed rules generally only apply to cross-border transactions involving related parties, as well as unrelated parties if the arrangement has been deliberately structured to produce a hybrid mismatch advantage.

If New Zealand were to adopt the OECD anti-hybrids recommendations, the rules would apply to foreign companies doing business in New Zealand as well as New Zealand-owned companies doing business offshore.

It is expected that most hybrid arrangements would be replaced by more straightforward (non-BEPS) cross-border financing instruments and arrangements following the implementation of the OECD recommendations in New Zealand.

Rules to counteract hybrid mismatch arrangements have been introduced in a number of countries. Notably, Australia and the UK are in the process of implementing the OECD recommendations into their domestic law. In addition, the European Council has issued a directive requiring EU member states to introduce anti-hybrid rules (currently on an intra-EU basis but expected to include arrangements involving non-EU countries in the future).

The purpose of this document is to seek comments on how the OECD recommendations could be implemented in New Zealand. Final policy decisions will only be made after the consultation phase. Part I of the document describes the problem of hybrid mismatch arrangements, the case for responding to the problem, and a summary of the OECD recommendations. Part II of the document explains the OECD recommendations in greater depth and discusses how they could be incorporated into New Zealand law.

Submissions

The Government seeks submissions on how the OECD recommendations should best be incorporated into New Zealand law.

Submissions should include a brief summary of major points and recommendations and should refer to the document's labelled submission points where applicable. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

Submissions should be made by 17 October 2016 and can be emailed to policy.webmaster@ird.govt.nz with "Addressing hybrid mismatch arrangements" in the subject line.

Alternatively, submissions may be addressed to:

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document with key interested parties.

PART I

Policy and principles

CHAPTER 1

Background

Historic focus on the problem of double taxation

1.1 The global international tax framework reflected in international tax treaties and countries' domestic tax rules recognises that income earned from cross-border activities is at risk of double taxation – once in the country where it is earned (the source state) and once in the country where the entity deriving the income is resident (the residence state).

1.2 Co-operation among countries regarding income taxation has been mostly concerned with this risk of double taxation – when an item of income is taxed under the domestic law of both the source and residence states and its harmful effects on cross-border trade and investment. The principal focus of international tax treaties has been on eliminating double taxation through allocating taxing rights over cross-border income between the residence and source states.

The problem of double non-taxation

1.3 Since late 2012, there has been growing awareness that the combination of different domestic tax rules and tax planning allows multinationals to pay little or no tax on their income anywhere in the world, if they choose to do so. This so-called double non-taxation (or less than single taxation) raises a number of tax policy issues. Many of the issues raised, such as distortionary effects and competitive concerns, are similar to those raised by double taxation.

1.4 The wide range of international tax planning techniques that are used to achieve double non-taxation are collectively referred to as "base erosion and profit shifting" or "BEPS". As BEPS strategies take advantage of weaknesses in the current international tax framework and/or gaps or mismatches that result from the interaction of the tax systems of different countries,[1] it is impossible for any single country, acting alone, to fully address the issue. Recognising this, the OECD and G20 have taken the lead on work in this area, with the aim of developing a co-ordinated global approach to addressing BEPS concerns.

> ***KPMG Comment:*** *Paragraphs 1.2 to 1.4 and footnote 1 highlight a fundamental problem with the BEPS project – a failure to agree/achieve consensus on what is the true source of income.*
>
> *In a hybrid capital mis-matches context this means focusing on the allocation of income for equity and debt.*

[1] The issues coalesce such that rules developed to allocate income among countries can be manipulated to shift income away from its "true" source to low tax countries.

Income is generally apportioned between the source and the use of the debt. Income is allocated to where equity is used as no deduction is allowed for the return on equity. Notably, no income is allocated to the country which provides equity capital.

Double taxation arises when there is no deduction for the return on equity and that return is taxed. The standard solution to the double taxation problem is to exempt income from equity in the capital providing country. This allows mis-matches in debt/equity treatment.

The fundamental problem is not the mis-match but the lack of a consensus on the allocation of the "true" source of income from equity. The OECD recommendations deal with this problem by further allocating income to the country where the capital is used.

This creates double taxation, at a minimum at the ultimate shareholder level, but also because it allows company and withholding tax to be applied.

G20/OECD Action Plan

1.5 The OECD approach has been to develop specific recommendations for countries to implement, either through changes to their domestic laws, through treaty provisions, or multilaterally. The aim has been to give countries the tools necessary to ensure that profits are taxable, and taxable where the economic activities generating the profits are performed and where value is created. The OECD released an Action Plan on BEPS on 20 July 2013, containing a comprehensive package of measures to address BEPS concerns.[2] New Zealand has participated in the Action Plan work and supported it, particularly the intention that a co-ordinated global approach be taken to addressing BEPS concerns. The final BEPS package of recommendations was released on 5 October 2015, approved by G20 finance ministers on 9 October 2015, and by G20 leaders during their annual summit on 15–16 November 2015.

KPMG Comment: *See our comment on the previous paragraphs.*

Hybrid mismatch arrangements

1.6 Hybrid mismatch arrangements are identified in the Action Plan as an important source of BEPS concerns. Action 2 of the Action Plan aims to neutralise their effects by developing model treaty provisions and recommendations regarding the design of domestic tax rules.

1.7 Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation (including long-term tax deferral) by, for example, creating two deductions for one borrowing or creating a deduction without a corresponding income inclusion. Mostly, the tax result comes from a mismatch of domestic laws, but double tax agreements can be used to enhance the tax benefit by, for

[2] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en (OECD BEPS Action Plan).

example, eliminating or reducing source state withholding taxes. It is often difficult to determine which of the countries involved has lost tax revenue, but there is a reduction of total tax paid.

1.8 With many hybrid mismatch arrangements involving New Zealand taxpayers, the exploited mismatch is between New Zealand and Australia's domestic rules. For example, a number of New Zealand taxpayers have been involved in recent tax avoidance litigation with the Commissioner of Inland Revenue (the Commissioner), which concern funding arrangements that exploit the different tax treatment between Australia and New Zealand of optional convertible notes (a hybrid financial instrument) issued by the New Zealand taxpayer to their Australian parent. Similarly, tax disputes have arisen between New Zealand taxpayers and the Commissioner over the tax effects of arrangements that exploit the different ways in which Australia and New Zealand treat Australian limited partnerships.

> ***KPMG Comment:*** *The hybrid mismatch, at least for the OCN, has been countered through New Zealand Court decisions. Officials have previously concluded that those decisions remain effective. (See Officials Report on the benefits of hybrid financing for New Zealand.) This suggests that, at least for this concern, a further domestic response is not required.*

OECD recommendations

1.9 As part of a first set of deliverables under the Action Plan, the OECD released a paper containing recommendations regarding hybrid mismatch arrangements in September 2014.[3] A final report was released in October 2015,[4] as part of the final BEPS package, containing further work on various remaining technical issues, and additional guidance and practical examples explaining the operation of the recommendations in further detail. The recommendations are for specific improvements to domestic rules to prevent mismatches arising and neutralise their effect, and for changes to the OECD Model Tax Convention[5] to deal with hybrid entities, and the interaction between domestic rules and the OECD Model. The recommended hybrid mismatch rules are primarily linking rules that seek to align the tax treatment of a hybrid entity or instrument with the tax treatment in the counterparty country, but do not otherwise disturb the commercial outcomes.

1.10 New Zealand already has some rules that deter and prevent hybrid mismatch arrangements from arising. However, the OECD recommendations on hybrid mismatch arrangements are comprehensive by comparison.

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[3] OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. http://dx.doi.org/10.1787/9789264218819-en (OECD 2014 Interim Report).
[4] OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241138-en (OECD 2015 Final Report).
[5] OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing. http://dx.doi.org/10.1787/mtc_cond-2014-en (OECD Model).

Implementation of OECD recommendations

1.11 With the release of the Final Report, along with the Action Plan as a package of recommendations, governments will now look to implement the results into their domestic rules. Although it remains to be seen where different countries will land in terms of implementation, there is an expectation that countries that are part of the consensus will act.

1.12 The United Kingdom and Australia have both already committed to implementing the OECD recommendations into their domestic law. In addition, EU member states have been issued a directive to implement anti-hybrid measures for transactions between EU members, with further action on rules applying to non-EU countries expected later this year.

> ***KPMG Comment:*** *The document does not address the position of the United States of America. Its position is significant for the global economy and global tax policy. We refer simply to publically available information on the USA's position on EU efforts to counter the "transfer of income from where it is truly sourced" as perceived by the EU but not by the USA. Refer the US Treasury response to the recent European Commission's State Aid decision against Ireland.*
>
> *We also note that the EU's position is itself not a settled position. We refer to Ireland's response to the same EU State Aid decision.*
>
> *In both cases, the response is consistent with our view that BEPS is about trade, jobs and tax policy because most countries will develop tax policy with regard to all three, not just the purity of tax policy. Taking the OECD's position and any particular country's view at face value is risky for New Zealand which traditionally has considered tax policy from a "purer" perspective.*

CHAPTER 2

Hybrid mismatch arrangements

2.1 A "hybrid mismatch arrangement", as defined by the OECD:[6]

> *… exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax countries to produce a mismatch in tax outcomes where the mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.*

KPMG Comment: *We note that the definitions proposed in Chapter 12 may, in our view, go beyond arrangements which exploit differences.*

We further note that the BEPS project does not acknowledge that domestic tax laws are generally deliberately drawn to achieve tax and other policy outcomes. We acknowledge that while this may not always be true, it should generally be true of countries with mature tax policy development processes.

New Zealand is in our view such a country. It should certainly be true of countries with sophisticated Revenue Authorities. We would count New Zealand and many of its trading partners as qualifying but note this is a subjective analysis. Therefore, where a country has adopted particular parameters such as legal form over substance for debt/equity treatment, these will be the result of specific domestic tax policy decisions.

The hybrid proposals presume these choices give rise to sub-optimal outcomes in need of remedy. However, this is potentially at the cost of fundamentally disrupting the original policy drivers and existing commercial arrangements.

Where sophisticated Revenue Authorities have not been able to have the line legislatively drawn to their satisfaction, a country implementing the OECD recommendations will overrule the other country's deliberate and in most cases democratically made domestic tax policy decisions.

At Paragraph 1.8 the document refers to the mis-match in Australia's and New Zealand's laws. There would be very few who would consider Australia unsophisticated in tax policy terms or in aggressively pursuing its position. To the extent that the OECD report assumes that Australia is unable to look after itself, that is clearly an incorrect assumption. Rather, the mismatch is an outcome of the lack of global consensus on debt/equity and

[6] OECD 2014 Interim Report at para 41.

entity treatments. The recommendations deal with this problem indirectly and potentially incoherently.

We have taken the use of "exploits" as a pejorative term. It may be intended to be descriptive – that this is an outcome that arises. In that case, where deliberate policy decisions have been made, it is less obvious that a response is required.

2.2 Thus, a taxpayer with activities in more than one country may have opportunities to escape taxation through the use of hybrid mismatch arrangements.

2.3 In the vast majority of cases, the tax outcome comes from a mismatch of domestic laws. However, double tax agreements can be used to enhance a tax benefit (for example, via the elimination or reduction of withholding taxes at source). The use of hybrid mismatch arrangements puts the collective tax base of countries at risk, although it is often difficult to determine which individual country has lost tax revenue under an arrangement.

KPMG Comment: *It makes sense for New Zealand to attempt to determine whether it is its revenue which is lost. It appears that the Government has not done the work to make this assessment (see the last sentence of Paragraph 2.3).*

If the expectation, that non-hybrid arrangements are used, is realised, we would expect that New Zealand as a net capital importer will raise less revenue. We assume debt with a higher interest rate and not equity will be the replacement funding.

Given that New Zealand may well lose revenue, we consider that work to confirm the revenue position should be done before proceeding.

2.4 Action 2 of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) calls for domestic rules targeting mismatches that rely on a hybrid element to produce the following three tax advantage outcomes:[7]

- *Deduction no inclusion (D/NI)*: Payments that give rise to a deduction under the rules of one country but are not included as taxable income for the recipient in another.
- *Double deduction (DD)*: Payments that give rise to two deductions for the same payment.
- *Indirect deduction no inclusion (indirect D/NI)*: Payments that are deductible under the rules of the payer country and where the income is taxable to the payee, but offset against a deduction under a hybrid mismatch arrangement.

2.5 The mismatches targeted are those arising in the context of payments as opposed to, for example, a mismatch arising from rules that allow a taxpayer "deemed" interest deductions for equity capital.

[7] OECD 2015 Final Report at para 6.

KPMG Comment: *It is unclear what the implication of this statement is for New Zealand's adoption of the recommendations. Will New Zealand be able to target "deemed" interest deductions for denial of a deduction? This is obviously key to determining whether there is a New Zealand fiscal benefit or not.*

2.6 In broad terms, hybrid mismatch arrangements can be divided into the following categories based on the particular hybrid technique that produces the tax outcome:

- *Hybrid instruments* exploit a conflict in the tax treatment of an instrument in two or more countries. These arrangements can use:
  - *Hybrid financial instruments,* under which taxpayers take mutually incompatible positions regarding the treatment of the same payment under the instrument;
  - *Hybrid transfers*, under which taxpayers take mutually incompatible positions regarding who has the ownership rights in an asset; or
  - *Substitute payments*, under which a taxable payment in effect becomes non-taxable by virtue of a transfer of the instrument giving rise to it.
- *Hybrid entities* exploit a difference in the tax treatment of an entity in two or more countries (generally a conflict between transparency and opacity).

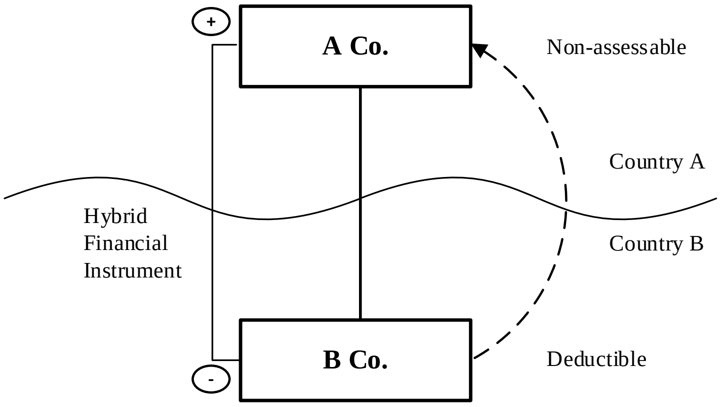
2.7 Hybrid entities and instruments can be embedded in a wider arrangement or structure to produce indirect D/NI outcomes.

Hybrid instruments

Hybrid financial instruments

2.8 A simple arrangement involving the use of a hybrid financial instrument is set out below.

Figure 2.1: Hybrid financial instrument[8]



2.9 Under the arrangement, B Co (resident in Country B) issues a hybrid financial instrument to its parent A Co (resident in Country A). Country B treats the instrument as debt, so that payments under the instrument are treated as deductible interest to B Co. Country A treats the instrument as equity, so that payments under the instrument are treated as exempt dividends (or otherwise tax relieved) to A Co. The tax outcome is D/NI.

2.10 A number of New Zealand taxpayers have had recent involvement in tax avoidance litigation with the Commissioner of Inland Revenue regarding their use of hybrid financial instruments in funding arrangements with their offshore parents.

2.11 In *Alesco New Zealand Ltd v Commissioner of Inland Revenue*,[9] the New Zealand Court of Appeal considered one such arrangement as a test case. The New Zealand taxpayer had issued optional convertible notes to its Australian parent; treated as part debt and part equity in New Zealand, but exclusively equity in Australia. Outside of tax avoidance, the tax outcome was D/NI: a New Zealand deduction for the interest notionally paid by the New Zealand taxpayer on the debt component of the notes,[10] but no interest income to the Australian parent for which it would otherwise have been liable for Australian taxation. The Court of Appeal's holding that the arrangement was tax avoidance was not based on the Australian tax treatment.

> ***KPMG Comment:*** *The document does not consider the effect of alternative funding and its effect on New Zealand's tax revenue. The Alesco OCN would seem to be a good case study. In that case, Alesco argued that the counterfactual – use of vanilla debt – would have resulted in the same or lesser tax outcomes for New Zealand.*
>
> *We note that Officials appear to be of the view that equity funding will replace hybrid debt funding. This is supported by analysis which says that debt funding into NZ is typically less than the safe harbour thin capitalisation rules. That is not unexpected. Additional debt is not*

[8] OECD 2014 Interim Report at p33.
[9] *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.
[10] With no New Zealand non-resident withholding tax (NRWT) liability.

readily introduced into New Zealand after the initial investment. Over time, the debt level can be expected to decrease as a percentage.

However, our experience is that debt levels, ***at the time of investment****, will approach the thin capitalisation safe harbour rate. The effect of New Zealand tax on the marginal investment has been the focus of tax policy. We consider debt, and not capital funding, is the better comparator. Simple debt is likely to attract higher interest and also higher cash outflows from New Zealand. This is likely to lead to both lower fiscal revenue and also lower capital retained in New Zealand.*

2.12 Apart from taxpayers formally bound by the *Alesco* ruling, a number of New Zealand taxpayers have, in recent times, entered into arrangements under which they have issued mandatory convertible notes (MCNs) to their offshore parents. Commonly, interest is accrued over the term of the arrangement, and at maturity, the issuer's interest obligation is satisfied by issuing shares. As New Zealand treats the MCN as debt, the arrangement gives rise to deductible interest to the New Zealand issuer,[11] but the issue of shares to satisfy the New Zealand issuer's interest obligation does not result in income to the offshore parent (that is, D/NI).

2.13 The Commissioner has challenged a number of the arrangements using MCNs as tax avoidance arrangements. Under recent Australian domestic rule changes, a D/NI outcome can potentially now be achieved using an MCN with cash interest payments. Previously, Australia's non-portfolio foreign dividend exemption would not have applied had cash interest (rather than the issue of shares) been paid under the MCN, because an MCN is not legal form equity.[12] Now, such payments would likely be exempt in Australia;[13] the amendments ensure that Australia's non-portfolio foreign dividend exemption applies to returns on instruments that are legal form debt but that Australia characterises as equity, as a matter of substance, under its debt-equity rules.[14]

KPMG Comment: *See our comments at Paragraph 2.11.*

2.14 A third common form of trans-Tasman hybrid financial instrument is frankable/deductible instruments issued by the New Zealand branch of some Australian banks to the Australian public.[15] Typically, these instruments qualify as bank capital for Australian regulatory purposes. As with the MCNs, the bank issuer claims a New Zealand tax deduction for the coupon on these instruments. The Australian tax treatment is different. The instruments are treated as equity for Australian tax purposes, but because they are held by portfolio investors, the return is taxable. However, the bank attaches franking credits to the coupon. The credits work in the same way as New Zealand imputation credits. The credits are not generated by the investment of the funds raised by issue of the

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[11] And no New Zealand NRWT obligation. ***KPMG Comment****: It is not clear why this result is obtained, the issue of shares to satisfy the interest would appear to still be interest (albeit it is not in cash).*

[12] Section 23AJ of the Australian Income Tax Assessment Act 1936 – repealed under item 1 of Part 1, Schedule 2 to the Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014.

[13] Although *prima facie* subject to New Zealand non-resident withholding tax. ***KPMG Comment:*** *It is not clear why the two qualifications are included, i.e. "Although prima facie .."?*

[14] The Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014 received Royal assent on 16 October 2014. The relevant provisions apply the day after Royal assent: section 2 and Part 4 of Schedule 2.

[15] See *Mills v Commissioner of Taxation* [2012] HCA 51.

instruments – because that income is earned by the New Zealand branch of the Australian bank it is not subject to Australian income tax. So the Australian bank obtains a New Zealand income tax deduction for a payment which for Australian tax purposes is treated in the hands of the payee as made out of fully (Australian) taxed income.

2.15 This type of instrument is considered in Example 2.1 of the Final Report, which concludes that it gives rise to a hybrid mismatch.

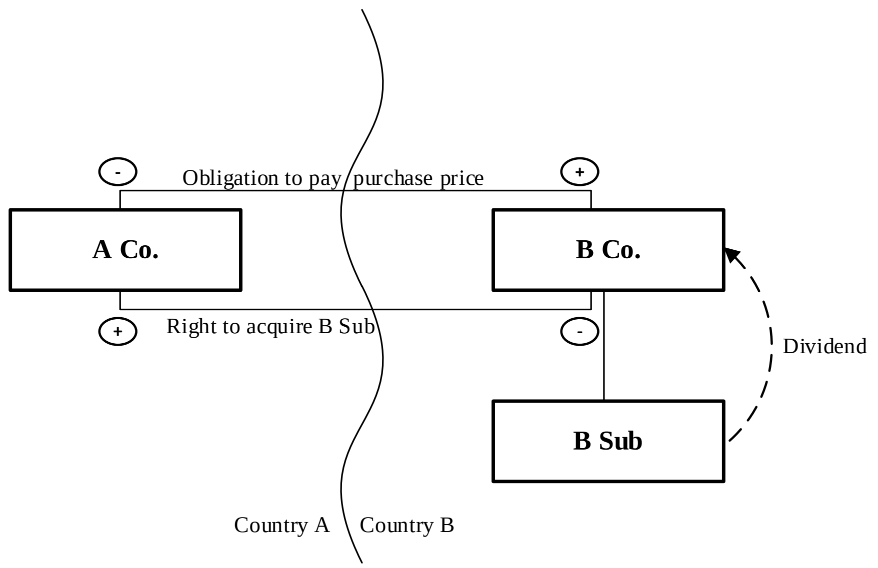
> ***KPMG Comment:*** *See our comments at Paragraph 2.11. Further, such instruments would typically reduce the interest rate by the franking credits attached. This, by definition, means that New Zealand will lose revenue from any replacement debt financing. (We would not expect such a branch to be capital funded in New Zealand. Capital funding would be raised outside New Zealand so that franking credits can be attached.)*

Hybrid transfers

2.16 A simplified arrangement involving a hybrid transfer is set out in Figure 2.2.

2.17 Typically, a hybrid transfer is a collateralised loan arrangement or share lending transaction where the counterparties in different countries are each treated for tax purposes as the owner of the loan collateral or subject matter of the share loan. In the arrangement set out in the figure below, the mismatch arises because Country A taxes the arrangement in accordance with its economic substance (a loan with the shares as collateral), while Country B (like New Zealand) taxes in accordance with the arrangement's legal form (a sale and repurchase or "repo" of the shares).

Figure 2.2: Hybrid transfer – share repo[16]



2.18 A Co (resident in Country A) owns B Sub (resident in Country B). A Co sells its B Sub shares to B Co under an arrangement that A Co will reacquire those

[16] OECD 2014 Interim Report at p35.

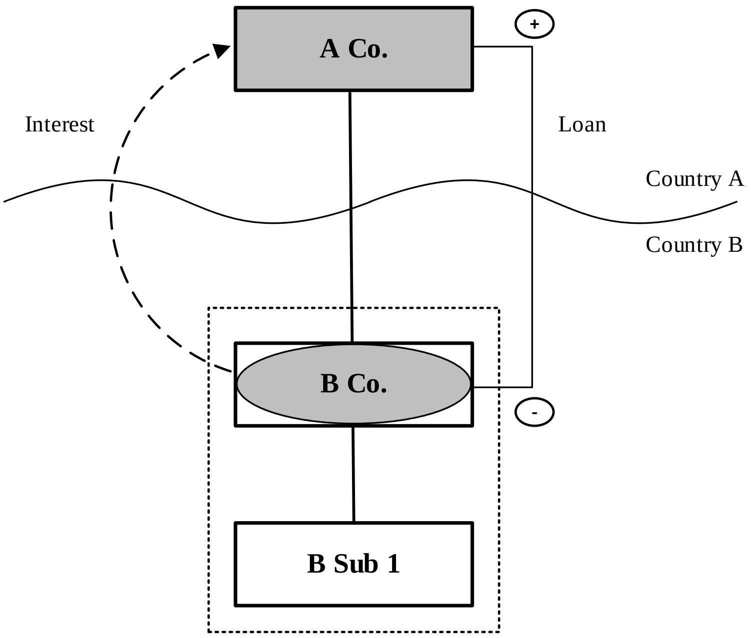
shares at a future date for an agreed price reflecting an interest charge reduced by any dividends B Co receives on the B Sub shares. Between sale and repurchase, B Sub pays dividends on the shares to B Co. In Country A, A Co is treated as receiving these dividends and paying them to B Co as a deductible financing cost. In Country B, B Co is treated as receiving the dividends, which are tax exempt. The tax effect is D/NI.

Hybrid entities

Disregarded payments made by a hybrid payer

2.19 A simplified arrangement involving the use of a hybrid entity to achieve a D/NI outcome is set out in Figure 2.3.

Figure 2.3: Disregarded payments made by a hybrid entity[17]



2.20 A Co (resident in Country A) indirectly holds B Sub 1 (resident in Country B) through B Co, a hybrid entity treated as transparent in Country A, but opaque in Country B. B Co borrows from A Co, and pays interest on the loan, which is treated as deductible in Country B. The deduction can be used to offset income in B Sub 1's group of companies in Country B. As Country A treats B Co as transparent (and as A Co is the only shareholder in B Co), the loan, and interest on the loan, between A Co and B Co, is disregarded in Country A (that is, a D/NI result).[18]

2.21 New Zealand unlimited liability companies are used to play the role of B Co in the figure above to achieve a D/NI (inbound) outcome. The United States'

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[17] OECD 2014 Interim Report at p42. The tax outcomes of the arrangement are described at paras 73–74. This structure is also at the core of Example 3.1 of the OECD 2015 Final Report at p288.
[18] The treaty implications relate to whether, and to what extent, Countries A and B are limited by the relevant treaty in taxing the income of A Co. Under the OECD Model, an amount arising in Country B is paid to a resident of Country A, so, *prima facie*, the benefits of Article 11 (Interest) would be granted.

domestic "check the box" rules allow a New Zealand unlimited liability company, treated as opaque by New Zealand, to be treated as transparent for United States income tax.

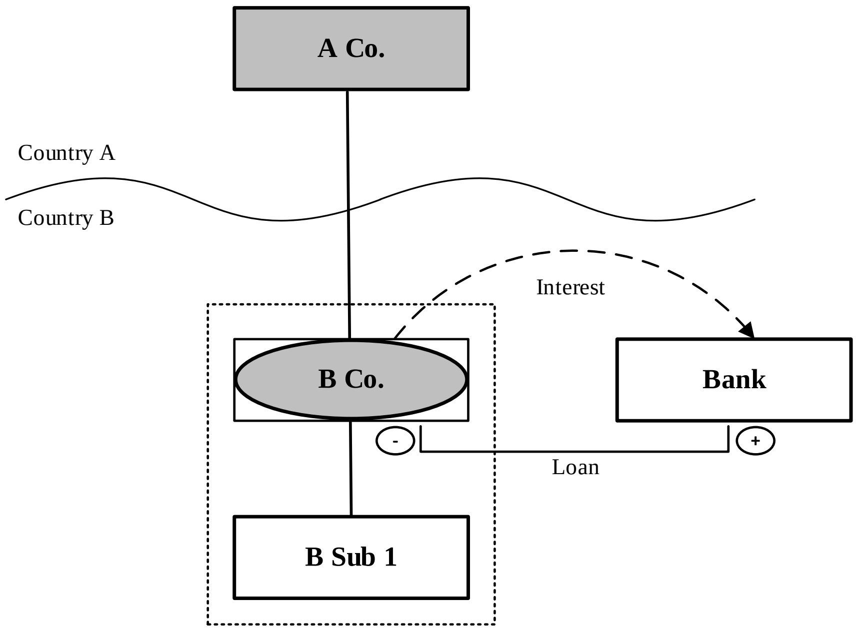
> ***KPMG Comment:*** *Given public statements, it seems unlikely that the US will adopt comprehensive hybrid mismatch rules. Their application in New Zealand will result in the primary rule (denial of interest deductions) applying to financing provided via US "check the box" companies. While this may, prima facie, be revenue positive for NZ, the impact on potential NZ borrowers (including the additional compliance costs) and alternatives needs to be considered.*

2.22 The creation of a permanent establishment in the payer country can be used to achieve a similar D/NI outcome. For example, a subsidiary company resident in an overseas jurisdiction could borrow from its parent company resident in the same jurisdiction. If the subsidiary allocates the loan to a New Zealand branch, the interest paid on the loan would be treated as deductible in New Zealand (but subject to New Zealand non-resident withholding tax). However, a tax consolidation of the subsidiary with its parent would mean that the interest payment is disregarded in the overseas jurisdiction.

Deductible payments made by a hybrid payer

2.23 A simplified arrangement using a hybrid entity to achieve a DD outcome is set out in Figure 2.4.

Figure 2.4: *DD* arrangement using hybrid entity[19]



2.24 Under the arrangement, A Co (resident in Country A) owns all the shares of B Co (resident in Country B). B Co borrows from the bank and pays interest on the loan, deriving no other income. As Country A treats B Co as transparent, A Co is treated as the borrower by Country A. However, as Country B treats

[19] OECD 2014 Interim Report at p51.

B Co as opaque, B Co is treated as the borrower by Country B. The result is a deduction for the interest expenditure in Country A and B (that is, a DD outcome). If B Co is consolidated for tax purposes with its operating subsidiary B Sub 1, B Co can surrender its tax deduction to B Sub 1, allowing two deductions for the same interest expense to be offset against separate income arising in Country A and Country B.

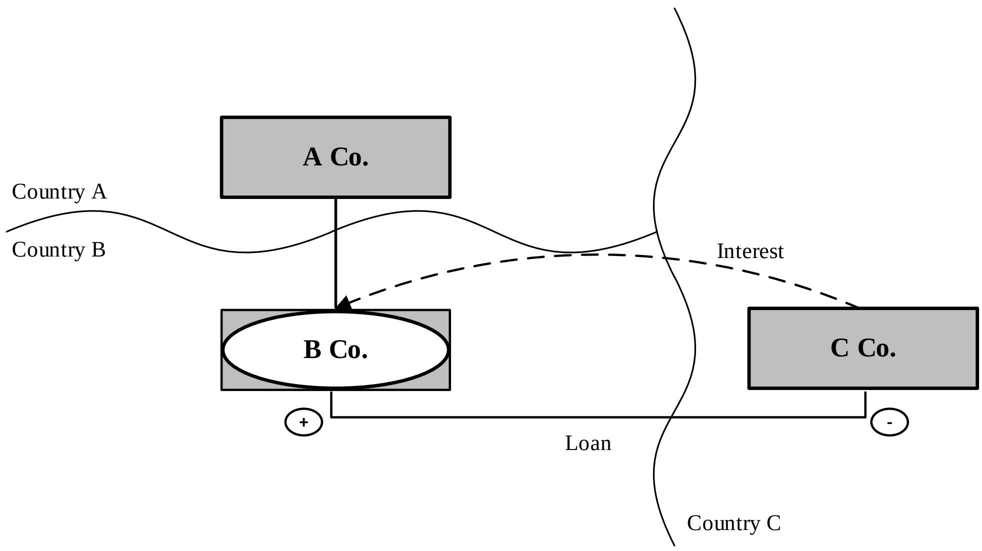
2.25 Australian limited partnerships (treated as transparent in New Zealand, but opaque in Australia) are used to achieve an outbound DD result in essentially the manner described in the example above.[20]

2.26 As with D/NI, the creation of a permanent establishment in the payer country can be used to achieve a similar DD outcome, if the income and expense of the permanent establishment is eligible to be consolidated or grouped for tax purposes in that country.

Reverse hybrids

2.27 A simplified arrangement using a reverse hybrid is set out in Figure 2.5. A reverse hybrid is a hybrid entity that is treated as opaque by its foreign investor, but transparent in the country of its establishment (in the reverse of the examples described above).

Figure 2.5: Payment to a reverse hybrid[21]



2.28 A Co (resident in Country A, the investor country) owns all the shares in B Co, (the reverse hybrid established in Country B, the establishment country). Country B treats B Co as transparent, but Country A treats B Co as opaque. C Co (resident in Country C, the payer country) borrows money from B Co and makes interest payments under the loan. The outcome is D/NI if the interest

[20] The Australian limited partnership (ALP) would have an Australian-resident partner and a New Zealand-resident partner, but the New Zealand-resident partner could hold up to 99.99 percent of the ALP in order to maximise the tax advantage (the DD outcome).
[21] OECD 2014 Interim Report at p45.

paid by C Co is deductible in the payer country (Country C), but not included as income under the domestic rules of either the investor or establishment country (Country A or B), because each country treats the income as having been derived by a resident of the other country, and Country B does not treat the income as sourced in Country B.

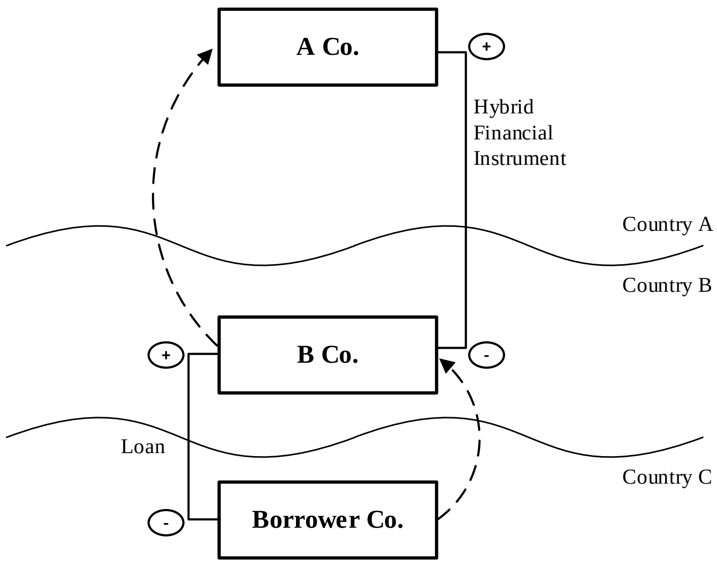
2.29 Controlled foreign company (CFC) rules in the investor country that tax the income of residents earned through CFCs on an accrual basis would eliminate such mismatches. However, New Zealand's CFC rules contain an active income exemption as well as a safe harbour, under which passive income is not subject to accrual taxation if it is less than 5 percent of total income.

> ***KPMG Comment:*** *This is another example where New Zealand's tax policy choices are being impacted by the hybrid proposals. NZ's previous international tax settings generally required accrual income attribution. This was replaced in favour of a tax regime more in line with that of the rest of the world. The decisions at the time contemplated that CFC income would generally not be taxed. We do not believe a global approach will see other countries amending their CFC settings, given the desire to maintain tax competitiveness.*

Indirect outcomes

2.30 The effect of a hybrid mismatch that arises between two countries can be imported into another country to create an indirect D/NI outcome, if the first two countries do not have hybrid mismatch rules. An example of this is set out in Figure 2.6.

Figure 2.6: Imported mismatch from hybrid financial instrument[22]



2.31 A Co lends money to B Co, a wholly owned subsidiary of A Co, using a hybrid financial instrument, so that payments under the instrument are exempt in Country A, but deductible in Country B. Neither Country A nor Country B has hybrid mismatch rules. Borrower Co then borrows from B Co. Interest

[22] OECD 2014 Interim Report at p59.

payable under the loan is deductible in Country C (Borrower Co's country of residence) and taxable income in Country B. The result is an indirect D/NI outcome between Countries A and C (Country B's tax revenue is unaffected as the income and deductions of B Co are offset).

2.32 It is difficult for tax investigators to detect imported hybrid mismatches, as detection requires a broad understanding of a taxpayer group's international financing structure. This information is often not publicly available, and can be difficult to obtain from the New Zealand taxpayer. However, if a country were to introduce hybrid mismatch rules without a rule against imported hybrid mismatches that could allow some taxpayers to seek to exploit that gap. This would be against the intended outcome of the rules which is that the tax advantages of hybrid mismatches are neutralised, leading taxpayers to, in most cases, adopt more straightforward cross-border financing instruments and structures.

> ***<u>KPMG Comment:</u>*** *<u>It is unclear how much or even why the risk of detection is mentioned at Paragraph 2.32. If there is no such rule, the risk of detection is irrelevant. If there is such a rule, New Zealand applies a self-assessment regime which places the onus on the taxpayer.</u>*
>
> *<u>The first two sentences should be discounted in confirming the policy position for New Zealand.</u>*

CHAPTER 3

Policy issues

3.1 Addressing hybrid mismatches is a key part of the G20/OECD Action Plan (Action Plan) to address base erosion and profit shifting (BEPS). The nature of BEPS means that countries must take a global perspective in tackling BEPS issues, and attempt to reach consensus on a co-ordinated response. In terms of hybrid mismatch arrangements, the double non-taxation result can only arise because of the lack of consistency in the tax treatment of an entity or instrument among countries.

3.2 In considering how best to respond to the problem of hybrid mismatch arrangements, the Government is aware that a non-OECD approach could be taken. For instance, some countries are of the view that not implementing the OECD recommendations is in their best interests. Another option is for New Zealand to introduce specific rules targeting the hybrid mismatch arrangements that are known to affect New Zealand.

3.3 This chapter discusses the merits for New Zealand of:

- adopting the OECD recommendations
- introducing a set of targeted anti-hybrid rules and
- doing nothing in respect of hybrid mismatch arrangements.

Global impact of hybrid mismatch arrangements

3.4 The ability of multinational enterprises with access to sophisticated tax advice to take advantage of hybrid mismatch opportunities may provide an unintended competitive advantage over businesses that cannot.[23] The OECD has found some evidence that multinational enterprises with tax planning opportunities tend to have greater market dominance and higher price mark-ups compared with other firms.[24]

3.5 This may lead to welfare losses. For example, the OECD has identified that reduced competition can reduce the need to innovate in order to stay ahead of competitors. Further, differences in the effective tax rate facing multinational enterprises able to exploit mismatches and other firms may also result in a sub-optimal allocation of capital if it means the multinational enterprise crowds out potentially more productive investment by other firms.[25]

[23] For example, the mismatch may allow the multinational to reduce its prices in the short term with a view to gaining a dominate market share (and then increase prices to increase profits).

[24] OECD (2015), *Measuring and Monitoring BEPS, Action 11 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241343-en (Action 11 Final Report) at p169.

[25] Action 11 Final Report at p170. The OECD also notes, however, that if tax planning multinational enterprises are more productive than the firms they crowd out, the overall effect on efficiency is unclear.

3.6 A related issue is that global resource allocation may be distorted by the availability of hybrid mismatch opportunities. International investment decisions may be made based on whether a mismatch is available rather than fundamental economics.

3.7 From a global perspective, hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by the parties involved as a whole. The use of these arrangements has caused a significant drop in worldwide corporate tax revenue, although precisely estimating this loss is a difficult task. Perhaps the best estimate comes from the OECD, which has put the reduction in worldwide corporate tax revenue due to mismatches and preferential tax regimes at between 1.3 and 3 percent (between US$33 and US$79 billion in 2014).[26]

3.8 The drop in tax revenues from the use of hybrid mismatch arrangements has real distributional consequences. It means governments must impose higher taxes elsewhere in their economies in order to deliver the desired level of public services. This reduces worldwide welfare. The costs associated with imposing tax generally increase more than proportionately as tax rates increase. Imposing higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrids is likely to be less efficient than imposing more moderate taxes across all economic actors.

3.9 Hybrid mismatch opportunities may also contribute to financial instability through increases in tax-leveraged borrowing, or as a result of businesses entering into investments which are uneconomic before tax, but marginally viable after tax as a result of taking advantage of such an opportunity.

3.10 Allowing the use of hybrids is also inequitable as it results in uneven tax burdens across different businesses. This is an issue in itself, but may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations.

3.11 The OECD's recommendations represent an agreement by participating countries that hybrid mismatch arrangements should be neutralised and also how they should be neutralised. While tolerating mismatches in some cases may have benefits to one country (at the expense of another), that behaviour carries a range of negative consequences. It harms competition, reduces worldwide revenue collection in an arbitrary and unintended way, results in inefficient investment decisions and damages the public's perception of the "fairness" of the tax system.

[26] Action 11 Final Report at p168. The method adopted by the OECD means that losses due to hybrids and preferential regimes cannot be disentangled.

KPMG Comment:

Action 11 Evidence
This section relies on the OECD's Action 11 October 2015 final report. That report is itself hedged on the economic impacts. The second summary of Chapter 1 states:

> *"This chapter concludes that the significant limitations of existing data sources mean that, at present, attempts to construct indicators of or undertake an economic analysis of the scale and impact of BEPS are severely constrained and as such should be heavily qualified." (at p17)*

In our view, this means that the economic and revenue effects of BEPS stated in these paragraphs should be, at best, weak evidence for the policy position being asserted in the document.

Market dominance

We note it is not clear whether tax planning opportunities create market dominance or can be used because of market dominance. To use UK examples, boycotts of Starbucks have not been matched for calls of boycotts for products and services of other companies. For a New Zealand example of the same point see ***link****.*

Strength of conclusions

We note the use of the conditional "may" in paragraphs 3.5, 3.6 and 3.9 of the document.

Hybrid results are or will become preferential regimes

We note the estimate of revenue loss is for hybrids ***and*** *preferential regimes. In our view, the distinction between a hybrid effect and a preferential regime as used by the OECD is arbitrary. In our view, at some point, a hybrid result will become a preferential regime.*

A country that does not originally tax an amount (based on whatever policy determinations it considers appropriate) will become aware the regime produces a double non-taxation result. If it does not change that result the regime becomes preferential (because by definition it is an acceptable and deliberate outcome).

We have not analysed the position in detail but it appears that the USA's hybrid results may be an example. The USA appears to continue to support such results because the WTO rules allow such tax policy approaches when they would prevent direct subsidies for exporting. A recent example of USA's concerns, albeit for VATs, can be found ***here****.*

As we understand it, this Bill proposes a tariff on goods imported to the USA from countries with a VAT where input tax is allowed. This is

said to be an unfair subsidy. Although it appears to mis-understand the nature of a VAT, it illustrates the desire of the USA to encourage its exporters.

Importance of perceptions of fairness and integrity and their correctness

We ***absolutely*** *acknowledge that perceptions of fairness and integrity of the tax system are important to the analysis of the hybrids recommendations. As this is the most concrete evidence (apart from "other countries are doing it as well") in support of the proposals it deserves more attention and consideration than it is given.*

In our view, the two main drivers of this perception are:

— *a sale made to a country should be taxed there; and*
— *income tax is borne by the company and it should be made to pay it.*

In the current environment, an expert view seems to be discounted but we would expect both Government and Officials to be cognisant of the nuances of both positions.

Source of sales income and the right to tax

The international consensus preceding the BEPS project has been that sales made ***in*** *a country can be taxed while sales* ***to*** *a country are outside the country's tax base. That is and has been New Zealand's position as well. The modern economy has raised fundamental questions of whether that should remain the case. Other BEPS actions seek to re-draw the border and are doing most of the work to re-align the international consensus.*

Our view is that the BEPS work broadens the concept of sales ***in*** *a country. It still does not extend to give taxing rights to sales* ***to*** *a country.*

Who bears the tax?

There is a significant literature on who bears the corporate income tax. Is it labour (i.e. workers and consumers) or capital? New Zealand's historical position has been that it is labour that bears New Zealand's income tax on inbound direct investment. Higher taxes means either higher costs for consumers, or lower returns for labour, or both. Lower taxes, other things being equal, benefit both.

The hybrid proposals instead rest on the assumption that the cost of the corporate income tax rests largely on direct capital and its foreign owners. There is, in our, view some justification for that position. Declared and recorded tax expenses can be expected to have an effect on the value of a multinational and therefore on the value of shareholders' interests in the company.

However, additional taxes may also have an effect on domestic consumers and labour. This is more difficult to see in the modern economy. Consumers do not see such effects as they receive many services "free". For example, no consumer in New Zealand is charged for a Google search. The search is "paid for" by advertising bought by companies. The cost is included in the charge for the products and services bought by the consumer. Such an indirect effect is not obvious. An increase in the charge may not therefore be material for a consumer.

We see nothing in the document which constitutes a rational analysis of the perception and whether, and to what extent, it should influence policy making. For example, an assessment of the correctness of the views may suggest the alternative is to provide better information on New Zealand's tax regimes and the underlying tax policy settings (and why they were chosen) to the wider community.

True source of income from equity and existing proxy allocations

Related to both views is the appropriate allocation of taxing rights for income from capital. Traditionally, full taxing rights are allocated to where capital is used. This treats equity capital income as sourced only where such capital is used.

However, where the capital is in the form of debt, both the country of source of the income (where the funds are used) and the country which provides the debt capital are entitled to tax the income. The country of source generally taxes the income at a lower rate by applying a withholding tax.

In our view, these rules, together with thin capitalisation rules for inbound foreign investment provide a proxy for the allocation of income from capital. This acknowledges that a foreign direct investor can employ debt or equity or a mixture of the two.

New Zealand's domestic law therefore already provides a boundary for taxing income which is considered to be "truly" income sourced in New Zealand.

A hybrid result should not fundamentally change that principled answer. It does not mean that income has not been appropriately allocated to New Zealand. New Zealand has already made that choice.

The case is simply that more tax will be raised at no cost?

Instead, what a hybrid result does is raise the question of whether there is an opportunity to increase the New Zealand tax take without raising the cost to the New Zealand economy. We understand that Officials may have answered this in the affirmative – there is no loss if

the amount would otherwise be taxed. (However, this is at best implied in the document.)

It is not obvious that this result has been well thought through. This is particularly the case as we understand that Australia is seen as the major source of hybrid mis-matches. Australia's franking regime, like New Zealand's imputation regime, creates a preference for domestic rather than foreign taxes. We would therefore expect a marginal loss for Australian investors from imposing greater New Zealand income tax. The decisions are therefore not costless.

The case for implementation is yet to be strongly made

For these reasons, we consider the document does not make the case for the OECD recommendations or at least for their "blanket" implementation in a strongly founded way. This makes it important to consider the specific recommendations carefully.

Uptake in other countries

3.12 The Australian Government asked the Australian Board of Taxation to consult on implementation of the OECD recommendations in 2015.[27] The Board released a discussion paper regarding implementation, inviting written submissions, on 20 November 2015,[28] and reported to the Australian Government in March 2016.[29] The Australian Government then committed to implementing the OECD's recommendations on hybrid mismatch arrangements anti-hybrid rules as part of its Budget 2016–17.[30] The Board has further been tasked with examining how best to implement the OECD recommendations in respect of hybrid regulatory capital and is due to report back by the end of July 2016.

3.13 The Government of the United Kingdom has already consulted on adopting the OECD's approach to addressing hybrid mismatches,[31] and has now introduced legislation to Parliament (see Schedule 10 of the Finance (No.2) Bill). The intention is that the legislation will have effect from 1 January 2017.[32]

3.14 The Council of the European Union adopted the Anti-Tax Avoidance Directive in June 2016, which sets out six anti-avoidance measures that all EU member states must implement into their own tax systems by 31 December 2018. One of the six anti-avoidance measures is to implement rules to counteract intra-

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[27] The terms of reference for this project can be found at http://taxboard.gov.au/consultation/implementation-of-anti-hybrid-rules/

[28] Board of Taxation, Implementation of the OECD anti-hybrid rules (2015). http://taxboard.gov.au/files/2015/08/BoT-Anti-hybrid-Discussion-Paper.pdf

[29] This report was subsequently released to the public on 3 May 2016. http://taxboard.gov.au/files/2016/05/Implementation-of-the-OECD-hybrid-mismatch-rules.pdf

[30] 2016–17 Budget Paper No 2 – Revenue Measures p34.

[31] HM Treasury and HM Revenue & Customs, *Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements* (December 2014).

[32] Refer to s 22 of the Schedule to Clause 33 (Hybrid and Other Mismatches) of the Finance Bill 2016 (United Kingdom).

EU hybrid mismatch arrangements.[33] The European Council, with reference to the OECD recommendations, has also asked the European Commission to propose rules by October 2016 that apply to hybrid mismatch arrangements involving non-EU countries.

3.15 Some countries have introduced domestic rules to combat the effects of hybrid mismatch arrangements prior to the OECD BEPS project or without explicitly following the OECD recommendations. These countries include Denmark, France, Spain, Mexico and Austria, while Germany and Hungary have proposed to introduce rules in the future.

KPMG Comment: *See our earlier comments.*

Australia's proposals may make New Zealand's proposals redundant for the majority of New Zealand's mis-matches. In other words, the ability for New Zealand to increase its tax take without cost may be limited but significant compliance costs and complexity will be introduced. This will not be welfare enhancing for New Zealand.

Given that outcome, New Zealand may be able to take a more targeted and limited approach to its own implementation of the OECD's recommendations.

This could be viewed as "opportunistic". However, we simply mean a better understanding of what the global landscape will look like prior to final decisions will lead to better outcomes for New Zealand. Those areas that need to be dealt with can be, others with no or little benefit can be deferred or not pursued at all.

In any case, other countries can be expected to take a national welfare approach to their tax policy settings; New Zealand should be no different.

At a minimum, consideration should be given to the interaction of Australia's proposals (once the detail of those proposals is clear) with New Zealand's to see whether that should produce a different recommendation for New Zealand.

Impact of hybrid mismatch arrangements on New Zealand

3.16 New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the tax effects of a hybrid mismatch arrangement (such as the arrangement in *Alesco*). However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way.[34] Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country

[33] Article 9 of Council Directive FISC 104 ECOFIN 628, 17 June 2016.

[34] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSSC 115, [2009] 2 NZLR 289 (SC).

involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements. This is also seen in Australia where the "black letter" tax treatment of the hybrid instruments in the *Mills* case referred to above was not reversed by the equivalent Australian anti-avoidance provision, on the basis that the tax benefit was incidental to the commercial benefit.

KPMG Comment: *The acknowledgement that the use of a hybrid arrangement is not necessarily artificial or contrived raises a significant issue. The use of "exploits" in the OECD definition implies an unintended effect. The breadth of the rules and even the examples used suggest that commercial arrangements will be affected by the proposals.*

Countering the hybrid results means that commercial arrangements will be influenced by the tax outcomes. A commercial choice will be limited by a perception that the intended domestic outcomes are inappropriate.

The hybrid proposals should not affect legitimate commercial choices (in a New Zealand context, this includes those allowed under other New Zealand tax regimes, such as the FIF rules).

3.17 The New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown. However, the tax revenue at stake is significant in the cases that the Government is aware of, which shows a clear advantage to counteracting hybrid mismatch arrangements. For example, the amount at issue under all funding arrangements comparable to the *Alesco* arrangement referred to in Chapter 2 was approximately $300 million (across multiple years).

KPMG Comment: *Given the result in Alesco, this amount of revenue is clearly not at stake. We assume that the Government does not mean to imply that Alesco was incorrectly decided.*

We further note, as above, that this is likely to significantly over-state the position. It assumes that equity instruments are the appropriate counter-factual rather than vanilla debt. A simple debt instrument is likely to give equivalent (or potentially higher) tax deductions in New Zealand. The revenue benefit will be offshore.

The same comments may apply to the next quoted revenue loss but this is not clear as the examples and calculations are not disclosed.

Further, in neither case, is there an assessment of the national welfare impact. The unanswered question is whether these amounts were invested in New Zealand?

In relation to hybrid entities, deductions claimed in New Zealand that are attributable to some prominent hybrid entity structures result in approximately $80 million less tax revenue for New Zealand per year.

3.18 However, it is possible that a particular hybrid mismatch will be to New Zealand's benefit (and to another country's detriment). If an arrangement results in the elimination of residence-country taxation, the return to the investor will increase while New Zealand will continue to earn the same level of tax revenue. The investor will have incentives to increase their investment in New Zealand.

3.19 On the other hand, a hybrid mismatch may also result in the elimination of tax in New Zealand. If the availability of the hybrid means the investor invests using the hybrid instead of equity – or crowds out investment by another investor who would have invested through equity – the result is a clear welfare loss for New Zealand. Tax revenues would fall and actual investment in New Zealand would remain unchanged.

> ***KPMG Comment:*** *The discussion does not make obvious the downstream effects of the "crowding out" of investment. It appears to assume a finite level of investment in New Zealand. The crowded out investment and the alternative investor will make other investments. Those downstream effects do not appear to have been factored into the analysis.*

3.20 Importantly, it is generally impossible to tell which of these situations will arise: whether a hybrid mismatch will result in the elimination of residence-country tax or the elimination of New Zealand tax. More broadly, even if it could be shown that New Zealand would be the beneficiary of a hybrid mismatch, it is an open question whether allowing the mismatch to be exploited would be appropriate. The double non-taxation benefits that arise from exploiting hybrid mismatches are (except in very unusual cases) not intended by either country.

> ***KPMG Comment:*** *The evidence would suggest that the comment about double non-taxation benefits not being intended is a mis-statement. There are public and obvious examples of hybrid results which have not been countered.*
>
> *The Government appears to be substituting the judgement of foreign revenue officials for the judgement of foreign Governments and parliaments for what is and is not intended.*

New Zealand would obviously welcome an intentional foreign policy that makes it more attractive for non-residents to invest here.

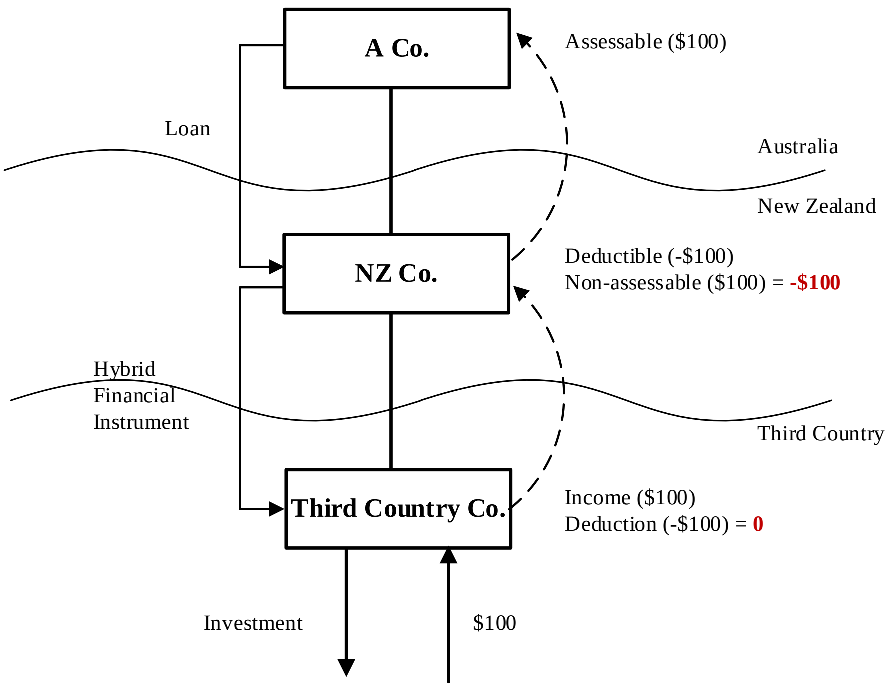
> ***KPMG Comment:*** *There are obvious examples of tax policies of foreign countries which do make it attractive to invest in New Zealand. These appear to be ignored by the document. These would include foreign regimes which do not tax foreign income either earned directly (e.g. territorial tax systems) or through certain entities (e.g. by CFCs), which do not tax certain domestic entities (for example, pension funds or charities) even if they invest offshore, or which do not tax equity income if a deduction is available in the source jurisdiction.*

A further obvious example is of a country which does not implement the hybrid recommendations. Any future hybrid results should be considered to be intended.

Allowing the exploitation of unintended mismatches in tax rules to achieve non-taxation of income is another matter.

3.21 The use of hybrid mismatches can result in losses to New Zealand in other ways as well. For example, hybrids have been an important feature of tax avoidance arrangements in recent history. A simple example using a hybrid financial instrument is illustrated in Figure 3.1 below.

Figure 3.1: Pure economic loss



3.22 Prior to the arrangement, A Co (resident in Australia) invests into a subsidiary, Third Country Co (resident in a third country) by way of a loan. Interest payable under the loan is deductible to Third Country Co under the third country's domestic rules, and taxable to A Co under Australia's domestic rules. However, A Co also has a subsidiary resident in New Zealand, NZ Co, paying New Zealand tax. Under the arrangement, A Co instead lends to Third Country Co through NZ Co, using a hybrid financial instrument on the New Zealand/third country leg. As a result, the group can obtain an additional deduction for its financing cost. The outcome is a pure economic loss to New Zealand – a reduction in New Zealand tax with no change in economic activity.

3.23 As other countries adopt the OECD recommendations, the case for New Zealand to also adopt the recommendations is strengthened. This is because, depending on how taxpayers react to the rules, a hybrid mismatch arrangement involving a New Zealand counterparty may still be countered (thus eliminating the benefit of the use of the hybrid to New Zealand, if there is one), but the tax collected would be by the counterparty country, rather than New Zealand due to the primary/defensive rule structure of the OECD recommendations. In

particular, there would likely be scenarios where Australia and the United Kingdom (who are both key sources of inbound and outbound investment for New Zealand) would counteract a hybrid mismatch arrangement involving New Zealand and collect all of the resulting revenue. These scenarios provide an incentive for New Zealand to follow Australia and the United Kingdom in adopting the OECD recommendations.

> ***KPMG Comment:*** *Paragraph 3.23 does not make sense. It follows a paragraph which says that New Zealand has an economic loss by allowing a deduction with no corresponding change in economic activity. If New Zealand introduces hybrid rules, it would presumably not allow a deduction so it would also have an increase in tax? Is the counter-factual that New Zealand will no longer be used to fund the third country and the tax will be collected by Country A? In that case, New Zealand still collects the tax because it does not provide a deduction?*

3.24 Further, hybrid mismatch arrangements involving New Zealand and other countries that do not adopt the OECD recommendations will be left unresolved unless New Zealand adopts the OECD recommendations.

3.25 However, instead of adopting the OECD recommendations in their entirety, New Zealand also has the option of introducing rules that specifically target the known hybrid mismatch arrangements affecting New Zealand, such as ALPs and MCNs. This approach may reduce complexity, as fewer rules would be needed (at least initially) in comparison to a full adoption of the OECD recommendations. However, it would be difficult to precisely identify the rules that would be needed and the rules that would not.

> ***KPMG Comment:*** *We consider that the difficulty is overstated. In any case, focusing on particular recommendations may allow appropriate early targeting of hybrid results which should be countered. This would allow time for fuller consideration of other issues identified in the document.*

Also, it is likely that taxpayers would respond to targeted rules by exploiting other tax planning opportunities left open by this approach. The Government is therefore of the view that adopting the comprehensive set of OECD recommendations at the onset is a proactive, and likely cleaner option. Adopting the recommendations in full also has the advantage of being consistent with the intended approach of Australia and the United Kingdom.

> ***KPMG Comment:*** *It does not however appear to be consistent with the current position of the USA (which we believe is unlikely to change)? What if any effect should this have on New Zealand's tax policy decision making?*

3.26 The Government's desire is that any new rules addressing hybrid mismatch arrangements should be effective from a policy perspective, but be as simple as possible to comply with and administer. In considering the need for simplicity, the Government will take into account the fact that in most cases,

the impact of hybrid mismatch rules will be to encourage businesses to use simpler structures which do not require the rules to be applied.

KPMG Comment: *The detailed proposals do not appear to take into account this principle of simplicity of compliance. We appreciate that there is an inter-connectedness – i.e. is there a hybrid problem and how simple is the countering measure – of the questions to be answered. In a number of cases, our view that there is no hybrid problem is supported by the complexity of the compliance and the commerciality of the arrangement.*

3.27 Taking the discussed factors and arguments into account, the best approach for New Zealand is likely to be to co-operate with other countries to eliminate hybrid mismatches by adopting the OECD recommendations. As noted above, when companies exploit hybrid mismatches, the result is that no tax is paid anywhere on a portion of income.

KPMG Comment: *See our earlier comments on the use of "exploit" in the document. This is inconsistent with descriptions of some hybrid results having commercial effects.*

This leads to an inefficient allocation of investment as cross-border investments where mismatches are available are subsidised relative to other investments. Eliminating this misallocation would increase worldwide efficiency, leading to higher worldwide incomes – which New Zealand will likely share in.

KPMG Comment: *The reference to NZ "likely" sharing in any benefit from increased allocative efficiency of investment decisions confirms our view that the benefit to New Zealand is founded on weak evidence and analysis. New Zealand should therefore proceed with caution and care.*

CHAPTER 4

OECD recommendations

4.1 The OECD's recommended domestic rules under Action 2 aim to eliminate the tax benefit of using a hybrid mismatch arrangement.

4.2 The most effective way to do this would be to harmonise the tax rules of the countries concerned. If, for example, all countries had the same rules for distinguishing debt from equity, the opportunity to arbitrage the debt/equity distinction would no longer arise. However, as harmonisation does not seem possible even for the most commonly exploited differences in tax treatment of instruments and entities, this approach is only theoretical.

> ***KPMG Comment:*** *This is consistent with our view that the OECD recommendations are pragmatic, rather than principled.*
>
> *The document does not answer the question of why harmonisation is not possible. The answers may include:*
>
> — *Countries are comfortable with the boundaries drawn by their domestic legislation. The hybrid effects are therefore intended;*
> — *The domestic results produce non-tax results which are deliberately sought by those countries;*
> — *Not all countries have sufficient policy resource to properly consider and promote good tax policy so that domestic rules reflect good tax policy.*
>
> *To the extent that hybrid rules increase income for the other country and not New Zealand, it is only the third answer which justifies New Zealand protecting other countries from themselves.*
>
> *We acknowledge that care needs to be taken on assumptions of other countries' and revenue authorities' capabilities (or lack thereof). Further, "good tax policy" will be in the eye of the beholder. What is good in the New Zealand context may not necessarily be good in other countries. This is particularly so if tax policy is used as a lever for other public policy objectives. Divergences in view will need to be accommodated.*
>
> *This suggests that New Zealand should consider the hybrid results for their effect on New Zealand only. The focus should be on whether New Zealand, as opposed to global welfare, is maximised by implementing the hybrid rules. This does not discount the benefit of a global response. That remains a relevant factor but should not be a sole factor.*

4.3 Instead, the OECD has recommended domestic rules that consist of:

- specific improvements to domestic rules designed to achieve a better alignment between those rules and their intended tax policy outcomes (specific recommendations); and

- rules that neutralise the tax outcomes of a hybrid mismatch by linking the tax outcomes of a payment made by an entity or under an instrument to the tax outcomes in the counterparty country (hybrid mismatch rules).

4.4 There is an expectation that the OECD's recommended rules be used as a template for reform. By doing so, a consistent approach to addressing hybrid mismatches will be applied across countries. Consistent rules that are consistently applied across countries will best ensure that the rules are effective at eliminating double non-taxation, while minimising the risk of double taxation and compliance and administrative costs for both taxpayers and administrators.

> ***KPMG Comment:*** *In our view, the recommendations do not pay sufficient attention to the potential for resulting double taxation. This may be because the expectation is that alternative arrangements will be entered into. This ignores the commercial effects of the hybrid arrangements.*
>
> *Further, in our view, the choices made to not limit the application of a rule are stated to be to reduce administration and compliance costs in preference to eliminating double taxation. This may be influenced by countries which have revenue authority assessment rather than self-assessment regimes. New Zealand's self-assessment regime means that such costs should have a lesser influence than double taxation.*

However, the proposed hybrid mismatch rules are designed so that the effects of a hybrid mismatch will be neutralised, even if the counterparty country has not adopted such rules.

4.5 This document proposes that New Zealand introduces domestic rules that are largely in line with the OECD recommendations, with only minor adjustments of those recommendations to ensure that they make sense in terms of New Zealand's other domestic rules and international tax framework. Final policy decisions will only be made on the outcome of consultation with the businesses that will have to apply any new rules.

Hybrid mismatch rules – OECD recommendations

4.6 The OECD recommendations include a series of "linking rules" which adjust the tax treatment of a hybrid mismatch arrangement in one country by reference to the tax treatment in the counterparty country, without disturbing any of the other tax, commercial or regulatory consequences.

4.7 The target of the rules is D/NI, DD and indirect D/NI mismatches that arise from payments. The OECD considers that rules that, for example, entitle a taxpayer to "deemed" interest deductions for equity capital, are economically more akin to a tax exemption, so do not produce a mismatch in the sense targeted.[35] The recommended rules are not generally intended to pick up mismatches that result from differences in the value ascribed to a payment.

[35] 2015 Hybrids Report at para 28.

For example, a mismatch in tax outcomes as a result of foreign currency fluctuations on a loan,[36] or differences due solely to timing. They do apply to deductions which, although attributable to payments, are not for the payments themselves, such as interest calculated under the financial arrangement rules.

KPMG Comment: *the deemed interest deduction example at Paragraph 4.7 not producing a hybrid mismatch is symptomatic of the inconsistency underlying the recommendations. What may be a deliberate design feature of one country's tax system (i.e. a tax exemption) may be (mistakenly or otherwise) considered by another country as giving rise to a hybrid result. The result will inevitably be inconsistent rules, and outcomes, across jurisdictions.*

4.8 While cross-border mismatches arise in other contexts (for example, the payment of deductible interest to a tax-exempt entity, or the sale of an asset from a capital account holder to a trader), the mismatches targeted are only those that rely on a hybrid element to produce the outcome.[37]

4.9 The OECD recommended rules are organised into a hierarchy, which takes the form of a primary rule and a secondary, defensive, rule. This hierarchy approach means that double taxation is avoided because the defensive rule only applies when there is no hybrid mismatch rule or the rule is not applied in the counterparty country. It also means that the effects of a hybrid mismatch are neutralised by the operation of the defensive rule even if the counterparty country does not have effective hybrid mismatch rules.

4.10 If New Zealand follows the approach adopted in the UK legislation, it is likely that these linking rules would form a separate subpart in the Income Tax Act.

KPMG Comment: *Our comments on the above paragraphs and those below are generally in the relevant chapters that follow.*

We note the importance of a clear set of rules which establish the priority of "ordinary" domestic rules, the new subpart and the application of the General Anti-Avoidance Rule (GAAR).

Recommendation 1: Hybrid financial instrument rule

4.11 The hybrid financial instrument rule applies to payments under a financial instrument that can be expected to result in a hybrid mismatch (that is, a D/NI result). A financial instrument can be either a financial arrangement or an equity instrument. The primary rule is for the payer country to neutralise the mismatch by denying the deduction. If it does not, the payee country should tax the payment. Countries only need to apply this rule to payments under financial instruments as characterised under their own domestic law. So, for example, a cross-border lease payment by a resident under an operating lease is not subject to this rule, even if the lessor country treats the lease as a finance lease.

[36] 2015 Hybrids Report at para 54.
[37] 2015 Hybrids Report at paras 91–98.

4.12 The rule also applies to substitute payments, which are payments under a transfer of a financial instrument which in effect undermine the integrity of the rules. This will be the case if the transfer and substitute payment secure a better tax outcome than if the transfer had not taken place.[38]

4.13 The reason for dealing with the deduction first is that it will generally be apparent that a deduction for a payment is being claimed in a country, and then it is possible to determine whether that payment is included in income in the payee country. However, it may not be as straightforward to identify the non-inclusion of a payment in income.

4.14 This rule only applies to payments between related parties (broadly, 25 percent or more common ownership) or under structured arrangements. A structured arrangement is defined in Recommendation 10. In broad terms it is an arrangement that is designed to produce a hybrid mismatch. These limitations are designed so that the rules apply in situations when the parties are able to obtain information about, or should be aware of, the tax treatment of the payment to the counterparty.

Recommendation 2: Specific recommendation for the tax treatment of financial instruments

4.15 The OECD's recommendations for specific improvements to domestic rules for taxing financial instruments are rules that:[39]

- deny a dividend exemption (or equivalent relief from economic double taxation) for deductible payments made under financial instruments;
- prevent hybrid transfers being used to duplicate foreign tax credits for taxes withheld at source, by limiting the amount of a credit to the amount of tax on the net income. A hybrid transfer is a transfer of a financial instrument where differences in two country's tax rules mean each treats the financial instrument as held by a resident.

4.16 This recommendation has no limitation of scope (for example, it is not limited to related parties or structured arrangements).

Recommendation 3: Disregarded hybrid payments rule

4.17 The third recommendation is to neutralise mismatches arising from payments (whether or not in relation to a financial instrument) by hybrid payers.

- The payer country should deny a deduction for a payment that gives rise to a D/NI outcome.
- If it does not do so, the amount should be included in income in the payee country.

[38] 2015 Hybrids Report at para 79.
[39] 2015 Hybrids Report at para 5.

- No mismatch will arise to the extent that the deduction in the payer country is offset against income that is included in taxable income in both the payee and payer country (dual inclusion income).
- Disallowed deductions can be carried forward and offset against dual inclusion income in future years.

So, for example, if a hybrid entity makes a deductible payment to its foreign parent, and that payment is disregarded in the parent country because it treats the hybrid entity as a part of the parent, then *prima facie* the country where the hybrid is resident should deny a deduction for the payment. If it does not, the parent country should tax the payment. Neither response is required if the hybrid entity in the same year derives an equal amount of income which is taxed in both countries (that is, is dual inclusion income).

4.18 This rule applies only to payments between members of the same control group, or parties to a structured arrangement. Entities are in the same control group if they are consolidated for accounting purposes, if they are commonly controlled, if they are 50 percent or more commonly owned, or if they are associated under Article 9 of the OECD Model Treaty.

Recommendation 4: Reverse hybrid rule

4.19 Recommendation 4 applies to any deductible payment made to a reverse hybrid which results in a hybrid mismatch. A hybrid mismatch arises if the payment is not taxable to the reverse hybrid in either its establishment country or the residence country of an owner, but would have been taxable if paid directly to the owner. *Prima facie* an interest payment made to a New Zealand zero-rate PIE in respect of the interest of a foreign investor in the PIE might well be subject to this rule (though it would be out of scope unless there were a structured arrangement). The rule is for the payer to be denied a deduction.

4.20 The rule applies where the payer, the reverse hybrid and its owner are in the same control group, and to a payment under a structured arrangement to which the payer is a party.

Recommendation 5: Specific recommendation for reverse hybrids

4.21 Recommendation 5 contains 3 specific recommendations for domestic rules relating to reverse hybrids. These are to:

- improve controlled foreign company (CFC) and other offshore investment rules to ensure the taxation of the income of hybrid entities in the investor country
- restrict the tax transparency of reverse hybrids that are members of a control group,; and
- encourage countries to adopt appropriate information reporting and filing requirements for transparent entities established in their country (for example, in the case of New Zealand, partnerships, trusts and PIEs).

Recommendation 6: Deductible hybrid payments rule

4.22 Recommendation 6 applies to payments by a hybrid payer who makes a payment that is deductible under the laws of both the payer country and the country of the owner, if the payment results in a hybrid mismatch. The owner country should deny the deduction, and if it does not, the payer country should do so. A payment will only give rise to a hybrid mismatch if it is deducted against income which is not dual inclusion income. Disallowed expenditure can be carried forward and offset against dual inclusion income in future periods.

4.23 A person will be a hybrid payer if they are entitled to a deduction for a payment in a country where they are not resident, and either they or a related person is also allowed a deduction for that payment in the residence country. They will also be a hybrid payer if they are entitled to a deduction for a payment in their residence country and the payment triggers a second deduction for an investor in the payer in another country.

4.24 There is no scope limitation on the primary rule. Disallowance in the payer country (the secondary rule) only applies if the parties are in the same control group or when the person is party to a structured arrangement.

4.25 In addition, the Final Report suggests countries may wish to apply this rule to deductions that are not directly attributable to payments, for example, depreciation.[40]

Recommendation 7: Dual-resident payer rule

4.26 Recommendation 7 applies to payments by a dual resident payer. If the payment is deductible in both countries, both should deny a deduction to the extent that it is offset against income which is not taxable in both countries.

4.27 As with Recommendation 6, Recommendation 7 includes an ability to carry forward any unused deductions and set them off against future dual inclusion income. Losses can also be used in one country if they have become unusable in the other (stranded losses). There is no limitation on the scope of this rule.

Recommendation 8: Imported mismatch rule

4.28 To expand the coverage of the rules, Recommendation 8 requires a payer country to deny a deduction for an imported mismatch payment to the extent the rules treat the payment as offset against a hybrid deduction in the payee country. This means that the rules can require disallowance even when the payee is returning the amount received as income, if there is the necessary degree of connection between the payee’s receipt of the payment, and the payee making a payment under a hybrid mismatch arrangement.

[40] OECD 2015 Final Report at para 192.

4.29 This rule is proposed to apply only if the payer is in the same control group as the parties to the mismatch arrangement, or when the payer is party to a structured arrangement.

Recommendation 9: Design principles

4.30 Recommendation 9 sets out the design principles for the OECD rules, and also their implementation and co-ordination at a domestic level. These are considered in more detail in Chapter 11.

Recommendations 10 – 12: Definitions

4.31 Recommendations 10–12 deal with definitions, including in particular, the definition of a structured arrangement, related persons, control groups and acting together.

Double tax agreement commentary

4.32 Chapters 13 and 14 of the Final Report intend to ensure that, through modifications to the OECD Model Tax Convention and its Commentary,[41] the benefits of double tax agreements (DTAs) are not inappropriately accessed through the use of hybrid instruments and entities:

- Chapter 13 provides commentary on a proposed change to Article 4(3) of the OECD Model Tax Convention whereby issues of an entity's dual residence can be resolved by the competent authorities of each DTA partner rather than through the application of an interpretative rule as to the place of effective management. The chapter also suggests a domestic law change deeming an entity not to be a resident of a state if that entity is considered to be resident of another state due to the operation of a DTA.
- Chapter 14 provides commentary on the proposed introduction of Article 1(2) to the OECD Model Tax Convention which deals with the treatment of (wholly or partly) fiscally transparent entities.

4.33 Where possible, the suggested changes will be incorporated into New Zealand's DTA network through the OECD's work on Action 15 of the BEPS Action Plan (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties), and through bilateral DTA negotiations.

4.34 Chapter 15 of the Final Report provides commentary on any potential conflict in the interaction of tax treaties and the OECD's domestic law recommendations. The Government does not foresee any potential conflict between the recommendations and New Zealand's DTA network. However, readers are welcome to submit on that point.

[41] OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing. http://dx.doi.org/10.1787/mtc_cond-2014-en

4.35 The DTA commentary will not be considered in Part II of this document as there is no domestic law reform that could be taken in this area (although the dual resident entity domestic law suggestion noted above is discussed in more detail in Chapter 9).

Submissions on Part I

4.36 Specific calls for submission are set out in Part II of the document. However, the Government is also open to submissions on any aspects of Part I of the document. Submissions should include a brief summary of major points and recommendations and should refer to the document's labelled submission points where applicable.

> ***KPMG Comment:*** *To reiterate our comments above, in our view, the benefit to New Zealand of adopting comprehensive hybrid rules is founded on weak evidence and analysis. New Zealand should proceed with caution and care. It should focus on direct New Zealand results and domestic outcomes to consider their appropriateness.*

PART II

Details of OECD recommendations

KPMG Comment*: As a general comment, we note that it would be easier to follow the arguments if the examples used labelled the New Zealand entity. The application of the current New Zealand rules and the proposed hybrid rules would be clearer. As a result, identifying whether there is a problem or not would also be clearer.*

CHAPTER 5

Hybrid financial instruments

5.1 This chapter discusses and asks for submissions on, various aspects of implementing the first two recommendations in the OECD's Final Report. It first considers changes to existing domestic rules (which relate to Recommendation 2), and then considers issues relating to the linking rules in Recommendation 1.

Recommendation 2

5.2 New Zealand already denies a dividend exemption for deductible and fixed-rate dividends (section CW 9(2)(b) and (c)). Indeed, the definition of a deductible foreign equity distribution contains a simple imported mismatch rule. While this rule seems in general satisfactory, there are two situations referred to in the Final Report which New Zealand law does not deal with.

Dividends giving rise to a tax credit in the payer jurisdiction

5.3 First, current New Zealand law does not deal with foreign tax systems that use tax credits triggered by dividend payments to effectively refund corporate tax. This is considered in Example 1.11 of the Final Report. Such a regime has the same effect as a dividend deduction,[42] and it is proposed that section CW 9(2)(c) be expanded to deny exemption for a dividend which gives rise to tax relief equivalent to a deduction in the payer jurisdiction.

> ***KPMG Comment:*** *The substance of the credit mechanism is that it allocates taxing rights away from the country of use of the equity capital. The logical conclusion is that income from equity is appropriately allocated and taxed by the country of use and the investor's country. That is what the FITC regime achieves.*
>
> *Further, the Example 1.1 analysis is form based. If Country B applied an 11.1% corporate tax rate, which provides the same effective tax rate as a credit for dividends, this rule would not apply. The logical conclusion of the Report's analysis is that all dividends should be taxable with a credit for underlying foreign tax paid. This is not the reality.*
>
> *Further, this would be a fundamental change which requires detailed consideration. We note specifically the costs of complying with a*

[42] The FITC regime involves a credit triggered by a dividend payment. However, this credit is used to satisfy the shareholder's withholding tax obligation, so is not equivalent to a partial deduction – see para 13 of Example 1.11, OECD 2015 Final Report. ***KPMG Comment:*** *Although this analysis is helpful to preserving New Zealand's position with regard to FITC, it illustrates the difficulties of determining whether there is a hybrid mis-match. This analysis takes a form approach. In other circumstances, the document appears to take a substance approach. The conclusion is that a hybrid mis-match is in the "eye of the beholder" (and in NZ's case, the FITC is not).*

dividend credit regime and its interaction with the CFC rules as key factors.

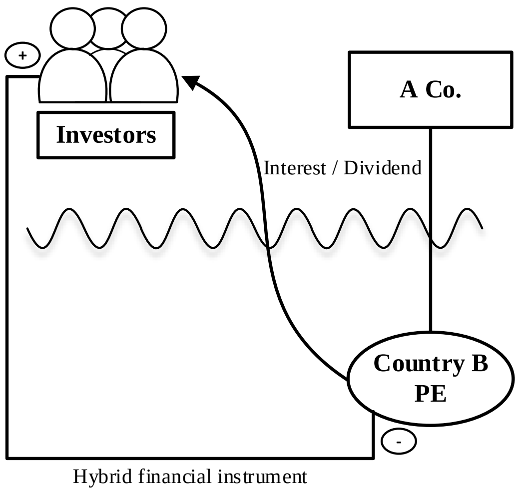
It appears that the mechanics of this proposal will be complex. It will require an apportionment of corporate tax to determine what is in effect deductible or not.

We further note that given activity in Country B and the effect of Country B's rules, it is difficult to see what alternative arrangements could be successfully used. Alternatives could be a branch of ACo, or a look through entity, which provides limited liability but does not attract the corporate tax credit for a distribution. Both of these appear to be at risk of the other recommendations applying – see Chapters 7 and 8 particularly. The rule will therefore affect commercial arrangements.

Denial of imputation credits

5.4 Secondly, there is no provision denying the benefit of an imputation credit to a dividend on a hybrid financial instrument. Example 2.1 in the Final Report (reproduced below as Figure 5.1) is an example of a deductible dividend with an imputation credit attached. The dividend is deductible in Country B because the instrument is treated as debt and funds the assets of the Country B branch. In Country A the dividend is taxed as a dividend and imputation credits are required to be attached to it by A Co, representing payments of corporate income tax to Country A. A number of Australian banks have entered into these types of transactions, in some cases using debt raised by their New Zealand branches, that is, New Zealand is Country B.

Figure 5.1: Application of Recommendation 2.1 to imputed dividends[43]



5.5 The Example states that under Recommendation 2.1 Country A should deny the imputation credit, because it is attached to income that has not borne tax in either state. It is true that the attachment of the credit to earnings which have not borne Country A tax may mean that A Co has retained earnings from its domestic activities which it is unable to distribute on a tax paid basis. In that

[43] OECD 2015 Final Report, Example 2.1, at p279.

sense the attachment of an imputation credit to a payment is less harmful than the payment being entirely exempt. However, in many cases the distribution of the untaxed earnings can be postponed indefinitely, so there is no practical distinction between exemption and full imputation.

5.6 Example 2.1 would not apply to a hybrid instrument issued by the foreign branch of a New Zealand company because New Zealand would tax the branch income. However, there seems no reason not to amend legislation to deny the use of imputation credits to reduce tax on a dividend which is deductible to the payer.

KPMG Comment: *A valid reason for not proceeding is that if New Zealand was Country A, it would not allow a deduction for the amount Country B recognises as interest. By definition, if imputation credits are attached, the amount must be a (non-deductible) dividend.*

The result would be a deductible amount in Country B, no deduction in New Zealand but the PE's income would be taxed in New Zealand. This is therefore not a hybrid mis-match result. It is countered by definition under existing domestic law.

This appears to be the case even if New Zealand proceeds with an active branch exemption. However, it may need to be considered in more detail should that occur.

The comment that "there is no practical distinction between exemption and full imputation" is only correct if retained earnings are never distributed. That has a commercial cost. Therefore, we do not believe there is direct equivalence.

5.7 In relation to Recommendation 2.2, New Zealand has a general rule limiting the ability to claim a credit for foreign tax to the amount of New Zealand tax chargeable on the net income that has been subject to the foreign tax. To ensure that this provision is more closely aligned with Recommendation 2.2, it is proposed that the definition of a "segment" of foreign source income be defined so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign source income.

KPMG Comment*: Foreign tax credit rules which require detailed tracing will generate tax planning to ensure that foreign tax credits are not "trapped" or are unusable. Further consideration of a separate rule is required.*

For example, as the income is a dividend, it would seem appropriate to treat this as dividend income rather than a separate segment. This is particularly the case as the only other dividends with foreign tax credits are likely to be deductible dividends. Dividends on share transfers are also taxable as deductible amounts. As they would be taxed for the same reason, they could be in the same segment.

Submission point 5A

Submissions are sought on the proposed approaches to implement Recommendation 2 where necessary.

Recommendation 1

General

5.8 The hybrid financial instrument rule in the OECD's Recommendation 1 applies to payments under a financial instrument that can be expected to result in a hybrid mismatch (that is, a D/NI result). A financial instrument can be either a debt or an equity instrument. For this purpose, an equity instrument would include any form of ownership interest in an entity which is not treated as fiscally transparent.

5.9 A simple example of a hybrid financial instrument is given in Figure 2.1 in Chapter 2.

5.10 A D/NI result arises when a payment is deductible to the payer, to the extent that that payment is to a person in a country where the payment would not be fully taxed within a reasonable period of time as ordinary income to a taxpayer of ordinary status, and a reason for that non-taxation is the terms of the instrument. Imposition of withholding tax on the payment by the payer country is not full taxation as ordinary income. D/NI outcomes can arise due to inconsistent characterisation of the financial instrument, or when the payer is entitled to a deduction before the payee has to include an amount in income (typically because the payer is on an accrual basis but the payee is on a cash basis).

5.11 The primary rule is for the payer country to neutralise the mismatch by denying the deduction. The payer country is any country where the payer is a taxpayer. It does not require the payer to be resident, and a payer can have more than one payer country. If the payer country does not deny the deduction, under the secondary rule the payee country should include the payment in the payee's income. The payee country is any country where the payee is a taxpayer.

Rule only applies to financial instruments under domestic law

5.12 Subject to two exceptions (considered below), countries only need to apply this rule to payments under financial instruments as characterised under their own domestic law. So, for example, a cross-border lease payment by a New Zealand-resident under a lease that is not a financial arrangement would not be subject to disallowance under this rule, even if the lessor country treats the lease payment as partially a return of principal under a finance lease.[44] The definition of a financial instrument is considered in Chapter 12.

[44] OECD 2015 Final Report, Example 1.25.

Rule only applies to payments

5.13 This rule only applies to payments between related parties (broadly, 25 percent or more common ownership) or structured arrangements. These definitions are discussed in Chapter 12.

5.14 The rule does not apply to deductions which are not for payments. Thus it does not apply to deemed deductions on an interest-free loan, but it does apply to deductions which arise from bifurcating an interest-free loan between debt and equity (Final Report, Examples 1.14 and 1.16). So, the deductions claimed by the taxpayer in *Alesco* would be disallowed by the primary rule in New Zealand, and if New Zealand did not have hybrid rules, be taxable in Australia under the defensive rule. They would not be affected by Recommendation 2, because Australia did not recognise the optional convertible note as giving rise to a dividend. The rule also does not apply to a bad debt deduction, which is attributable to a non-payment, rather than a payment – see Final Report, Example 1.20.

***KPMG Comment**:*

The full effect of the recommendation is unclear.

The effect of the defensive rule

The paragraph implies, but does not confirm, that if New Zealand has the primary rule that its application is determined by ignoring the fact of Australia having the defensive rule. (This is the most likely scenario, given other references to Australia in the document.) We understand that this would mean that New Zealand would deny the deduction.

If so, this is an example of New Zealand applying the hybrid rules because there is no cost to doing so (it would be taxed in Australia if the deduction was not denied). This is not necessarily a "tax at a no cost" result. Tax paid in New Zealand has a different result from tax paid in Australia.

We would expect the application of the primary rule would therefore more likely than not result in different funding arrangements. As this is more likely to be debt funding, New Zealand will not increase its revenue.

Does section BG 1 still apply?

Section BG 1 was found by the Courts to apply to the Alesco facts. To the extent that continues to apply, there is no additional New Zealand tax raised by the hybrid mis-match rule.

In Alesco the taxpayer was allowed a deduction under New Zealand's black letter law. It was denied a deduction because the GAAR applied.

The proposal is that New Zealand denies a deduction if the amount is not taxable. This will be part of New Zealand's black letter law.

It is not clear whether, if Australia taxes this amount (by operation of a substantive rule or because of the defensive rule if our understanding on the primacy of the hybrid rules is incorrect), that means that the outcome (D/T) will be contemplated as the hybrid rules do not apply. The GAAR may not apply. The seemingly perverse outcome of implementing the hybrid rules ***may*** *be that New Zealand allows a deduction. This is caused by Australia taxing the amount. (This is not intended to be a full analysis of BG 1 should the hybrids proposals proceed. It illustrates the types of issues which it will raise and which are not covered in the document.)*

This confirms our general point that New Zealand's domestic rules have been developed for good reason. New Zealand's rules should be focused on achieving the outcomes that New Zealand desires independent of other countries' rules.

Further, see our comments at chapter 11 on the need to clearly establish the relationship between the hybrid rules and the GAAR.

Recommendation 2

We understand the reference to recommendation 2 is simply to confirm that Australia's implementation of recommendation 2 would not apply to tax the amount (as there is no payment).

Practical considerations

5.15 This rule would mean that any person claiming a deduction for New Zealand tax purposes under a cross-border financial arrangement needs to consider, before claiming the deduction, whether:

- the deduction arises as a result of a payment that (assuming no change in the parties to the arrangement) is or will be made to a related person (applying a 25% threshold, as discussed below) or pursuant to a structured arrangement; and (if the answer to the first question is yes)
- whether under the laws of the country of the payee, the payment would be taxed as ordinary income in the hands of a taxpayer of ordinary status within a reasonable period of time. If it would not, then no deduction can be claimed.

5.16 Also, any person entitled to receive a payment under a cross-border financial instrument will need to consider, if that payment is not fully taxable (including where it is taxable but carries a credit, other than for foreign withholding tax), whether:

- the payment is from a related person or pursuant to a structured arrangement; and (if the answer to the first question is yes)
- whether under the laws of the country of the payer, the payment is deductible to a taxpayer of ordinary status. If it is, then the payment is taxable in the year of the deduction.

Particular tax status of counterparty not relevant

5.17 Only hybrid mismatches that arise as a result of the terms of an instrument are relevant. For example, if a New Zealand borrower pays interest to a related party who is tax-exempt, there will be no hybrid mismatch if the related party would have been taxable on the interest were it not tax-exempt. However, there will be a hybrid mismatch if the related party would not have been taxable on the interest if it were not tax-exempt (Final Report, Example 1.5).

5.18 Another issue is the relevance of deduction or inclusion that arises only because a payer or payee holds an instrument on revenue account. Generally the principles expressed above mean that such deductions or inclusions are ignored for purposes of this rule. For example, suppose a purchaser on revenue account is entitled to a deduction for the cost of acquiring a financial instrument whereas the vendor if on capital account does not include the sale price in its income. That mismatch does not mean that the hybrid financial instrument rule applies to the payment (see Final Report, Example 1.28).

Differences in valuation of payments not relevant

5.19 A borrower in a foreign currency loan will generally have a foreign currency gain or loss with respect to the loan. Assuming the loan is in the currency of the lender's residence, the lender will have no corresponding gain or loss. If the borrower has a loss, the loss is not thereby denied under the hybrid mismatch rules (Final Report, Example 1.17). The situation would be the same if the loan were in a third currency, even if currency movements mean there is a foreign exchange loss to one party and a foreign exchange gain to the other.

5.20 However, differences in valuation that lead to different characterisations of a payment may lead to Recommendation 1 applying – see Final Report Example 1.16, relating to an optional convertible note.

Timing differences

5.21 Where the payer and payee under a financial instrument are in different jurisdictions, it is not uncommon for them to recognise income/expenditure from the instrument on different bases. For example, a payer may be entitled to a deduction for a payment on an accrual basis, whereas a payee is taxable on a cash basis. In that case, there is a hybrid mismatch, which is *prima facie* subject to Recommendation 1.

5.22 The Final Report suggests[45] that a deduction should not be denied if the payment giving rise to the deduction is included in income in an accounting period that begins within 12 months of the end of the period in which the deduction is claimed. If this test is not met, the payer should still be entitled to a deduction if it can satisfy the tax authority that there is a reasonable expectation that the payment will be made within a reasonable period of time, and once made will be included in ordinary income. A reasonable period is

[45] From p34.

one that might be expected to be agreed between arm's length parties. Final Report Example 1.21 applies these principles.

5.23 The Final Report does not provide for any denied deductions to be carried forward and allowed if and when the payee does recognise income.

5.24 The UK appears to have adopted this approach, along with a provision that if a supposition ceases to be reasonable, consequential adjustments can be made.

5.25 The Australian Board of Taxation Report recommends a different approach. It suggests that a gap of up to three years between deduction and inclusion should not attract operation of the rule, whereas a longer gap should mandatorily do so. It also suggests that any deduction denial should reverse when and if the payee recognises the corresponding income. This is essentially a carry-forward loss proposal. The proposal seems to mirror what would happen in the case of inclusion under the defensive rule. If the amount of a deduction in a payer jurisdiction were included in the payee's income under the defensive rule, and the payment giving rise to the income inclusion was later received, it would not be appropriate to tax the payment again, and rules against double taxation would generally achieve this. This supports the Board of Taxation carry-forward proposal in relation to the primary rule.

Taxation under other countries' CFC rules

5.26 When a payment gives rise to a D/NI outcome, tax may still be imposed on the payment under a CFC regime. In this case the tax would be imposed on the owners of the payee, by the owner country. This is discussed at paragraph 36 and following of the Final Report. The Report gives countries the choice as to whether to treat CFC inclusion as taxation of the payee. This would be relevant for a New Zealand taxpayer in:

- determining whether to apply the primary response – in this case the New Zealand payer would need to establish that the payment made by it was subject to tax in the hands of the payee's owners under a CFC regime; or
- determining whether or not to apply the secondary response – in this case the New Zealand payee would need to establish that the payment made to it was subject to tax in the hands of the payee's own owners under a CFC regime.

5.27 The Report also says that a taxpayer seeking to rely on CFC inclusion should only be able to do so if it can satisfy the tax authority that the payment has been fully included under the laws of the CFC country. Unlike the general approach in Recommendation 1, this will require proof of actual taxation of the amount.

Application of rule to transfers of assets

5.28 Recommendation 1 generally does not apply to amounts paid for the transfer of an asset. However, transfers can give rise to hybrid mismatches in three different situations.

Portion of purchase price treated as payment under a financial instrument

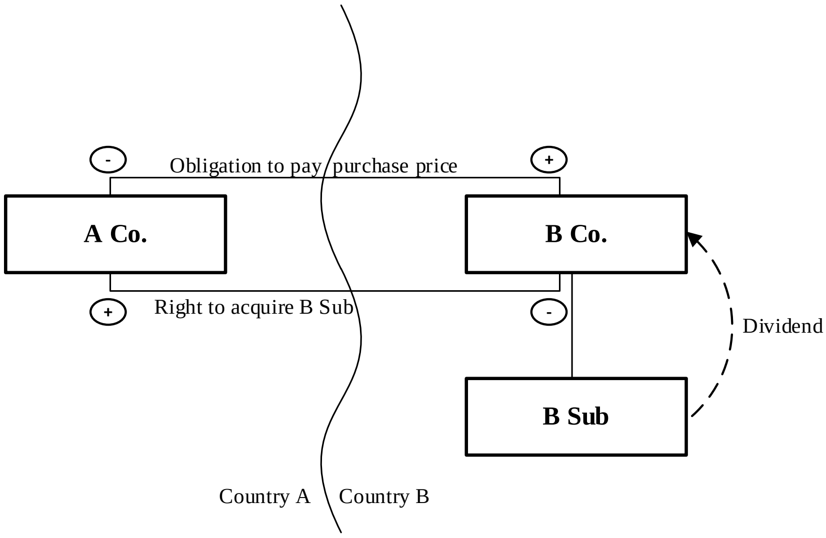
5.29 First, there may be a hybrid mismatch in a cross-border asset sale if one or other country treats a portion of the purchase price of any asset as attributable to a financial instrument (see Example 1.27 of the Final Report). For example, if a purchaser is *prima facie* entitled to a deduction for a portion of a deferred purchase price under the financial arrangement rules, but the non-resident related party vendor treats the entire amount as purchase price, the hybrid financial instrument rule will deny the purchaser a deduction. Because the application of the rules depends on the tax treatment of a payment for a taxpayer of ordinary status, the linking rule will apply to deny a deduction even if the non-resident vendor is a trader and treats the purchase price as income for purposes of its home country taxation (Example 1.29 of the Final Report).

5.30 The Final Report also states that when a person is entitled to a deduction for a payment only because the person holds an asset on revenue account, and the person is fully taxable on their economic gain or loss from the asset, that deduction should not be denied by the linking rule (see Final Report paragraph 52 and Example 1.28). So if the purchaser in the previous paragraph is entitled to a deduction for a payment because it is a trader, that deduction should not be denied.

Hybrid transfers

5.31 A second way the hybrid financial instrument rule can apply to a transfer of an asset is if it is a hybrid transfer. A hybrid transfer is a transaction, such as a share loan or a share repo, where the transferor and transferee are both treated as the owner of a financial instrument. This is usually because the terms of the transfer require both that the asset, or an identical asset, is returned to the transferor, and also that the transferor is compensated by the transferee for any income from the asset that arises during the term of the arrangement (whether or not received by the transferee). This means that economic risk on the asset remains with the transferor throughout the period from the initial transfer through to the retransfer. An example of a hybrid transfer is given in Figure 2.2 in Chapter 2 of this document, which is repeated here for convenience. Further examples are the transactions that were the subject of *BNZ Investments Ltd v CIR* (2009) 24 NZTC 23,582 and *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834.

Figure 5.2: Hybrid transfer – share repo (repeated Figure 2.2)



5.32 New Zealand is generally a form country, so in Figure 2.2, if B Co (the share borrower) is a New Zealand company it will be treated as owning the B Sub shares, and deriving a dividend from B Sub, rather than as having lent money to, and deriving a financing return from, A Co. However, because Country A is a substance country, A Co is treated as owning the B Sub shares, receiving the dividend, and making a deductible financing payment to B Co, equal to the amount of the dividend. Accordingly, if Country A does not have hybrid rules, and A Co and B Co are either related parties or the repo is a structured arrangement, then the effect of the hybrid transfer rule is that B Co will have to recognise additional income, unless it is taxable on the dividend from B Sub with no imputation credits.

5.33 In the case of a share loan which is a hybrid transfer, the hybrid mismatch will generally arise because:

- the manufactured dividend payment made by the share receiver to the share supplier in the substance country is treated in the same way as a dividend in the share supplier country, which will often be exempt;
- the same payment will often be deductible to the share receiver in its country.

Substitute payments

5.34 The third situation in which the hybrid financial instrument rule can apply to a transfer of a financial instrument is if the transfer involves a "substitute payment" (as defined). A substitute payment is a payment under a transfer of a financial instrument which represents a financing or equity return on the underlying instrument and which undermines the integrity of the hybrid rules. This will be the case if the underlying payment (that is, the one that gives rise to the substitute payment):[46]

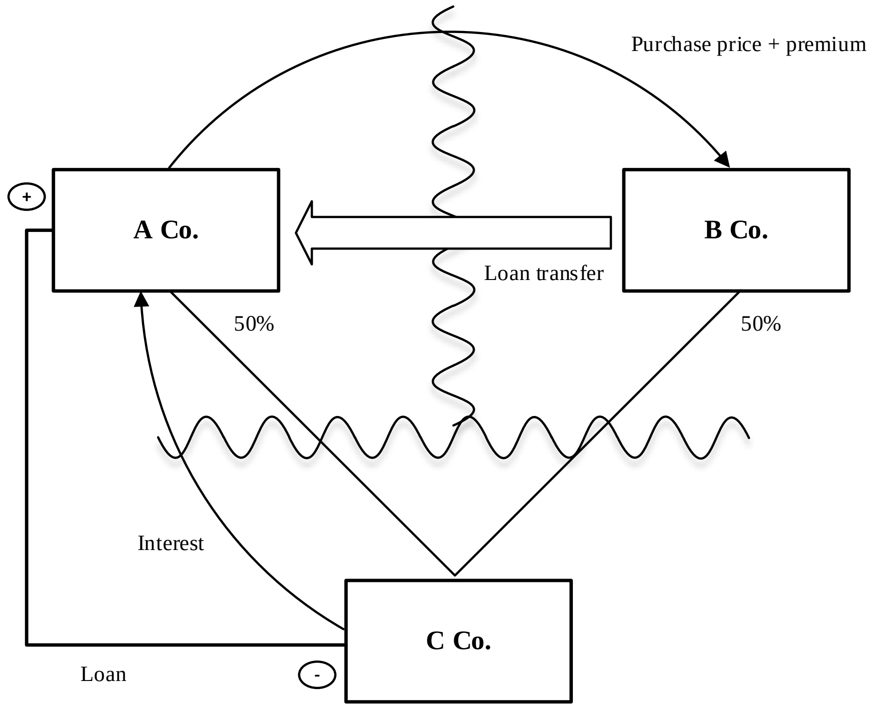
[46] OECD 2015 Final Report at para 79.

- is not included in the income of the substitute payer;
- would have been included in the income of the substitute payee; and
- gives rise to a hybrid mismatch.

5.35 In any of these circumstances, if the substitute payment gives rise to a hybrid mismatch, the hybrid rules will deny a deduction to the payer (primary response) or tax the payee (secondary response).

5.36 Example 1.36 of the Final Report shows a substitute payment, and is reproduced below.

Figure 5.3: Deduction for premium paid to acquire a bond with accrued interest[47]



5.37 The substitute payment is the premium portion of the amount paid by A Co to B Co for the transfer of the bond with accrued interest. The transfer is neither a financial instrument, nor a hybrid transfer. However, the premium is a payment in substitution for the payment of the accrued interest. It is deductible to A Co and treated as a capital gain to B Co, so it gives rise to a hybrid mismatch. On the facts of the example, the payment by A Co to B Co is a substitute payment because the payment of the coupon to the vendor would itself have given rise to a hybrid mismatch. The result would be the same if the coupon payment were taxable to the vendor. Accordingly, if the purchaser and vendor are related, or the sale is a structured arrangement, the payment of the premium will be subject to the hybrid mismatch rule.

[47] OECD 2015 Final Report, Example 1.36, at p274.

Regulatory capital

5.38 The Final Report gives countries the option to exclude regulatory capital from their hybrid rules. A typical example is when the parent company in a multinational banking group issues regulatory capital instruments to the market for the purpose of using the funds to provide regulatory capital to a bank subsidiary in another country. Countries are free to exclude the intra-group regulatory capital from the hybrid rules. The Final Report also states that an exclusion of bank regulatory capital from one country's rules does not require any other country with hybrid rules to refrain from applying them to regulatory capital instruments between the two countries.

Other exclusions

5.39 Recommendation 1.5 provides an exception to the primary response for investment vehicles that are subject to special regulatory and tax treatment that:

- is designed to ensure that while the vehicle itself has no tax liability, its investors have a liability, arising at more or less the same time as the gross investment income was derived by the investment vehicle; and
- ensures that all or substantially all of the vehicle's investment income is paid and distributed to the owners within a reasonable period after the income is earned; and
- taxes the owners on the payment as ordinary income.

5.40 An example is a regulated real estate investment trust, which is entitled to a dividend paid deduction but required to pay out all of its earnings on a current year basis.

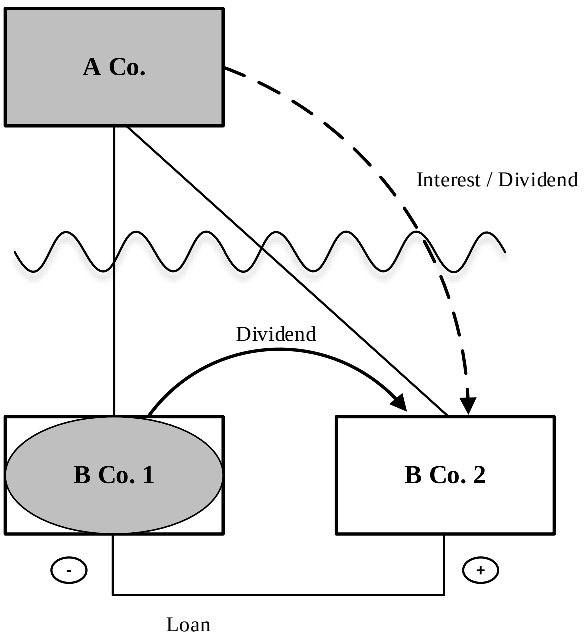
Application to New Zealand

5.41 A number of issues are worthy of further discussion and submission as to how Recommendation 1 could be incorporated into New Zealand law.

Applying the secondary rule to hybrid dividends

5.42 In New Zealand's case, the secondary rule (taxation of amounts that are deductible in the payer jurisdiction) will also require the denial of imputation credits attached to a dividend which is deductible in another jurisdiction. This could arise in the situation set out in Example 1.23 of the Final Report, reproduced below, where New Zealand is Country B.

Figure 5.4: Payment by a hybrid entity under a hybrid financial instrument[48]



5.43 Accordingly, the Government proposes to amend the law so that imputation credits attached to a dividend on a hybrid financial instrument are not included in a New Zealand shareholder's income and do not give rise to a tax credit. This non-inclusion would not affect the paying company. This ensures that application of the rule does not allow two lots of imputation credits to exist for what is in reality the same income. Denial of one amount of imputation credits correlates with the fact that the dividend payment has given rise to a foreign tax benefit.

5.44 As this example makes clear, implementing the defensive rule in Recommendation 1 will also require New Zealand to tax intra-group dividends that give rise to a hybrid mismatch under the hybrid financial instrument rule, even if these are between members of a 100 percent commonly owned group (whether or not consolidated).

> ***KPMG Comment:*** *In both cases, the proposals protect the foreign country's, and not New Zealand's, tax base. The dividend is correctly treated as capable of having imputation credits attached and as being exempt under New Zealand's domestic rules.*
>
> *In the first scenario, it is not clear whether B Co 2 would still have imputation credits received recorded in its ICA. These may be important to ensure that there is no double taxation when profits are ultimately distributed. However, further ICs may not be required as tax paid by B Co 2 on the dividend would generate imputation credits.*

[48] OECD 2015 Final Report, Example 1.23, at p235.

Submission point 5B

Submissions are sought on whether there are any issues with the proposed approach in applying the secondary rule to hybrid dividends.

Timing mismatches

5.45 With respect to timing mismatches, the Australian Board of Taxation approach (see earlier paragraph 5.25) may have advantages for New Zealand. Denial of deductions (with carry forward) where there is a deferral of recognition of the corresponding income for more than three years:

- applies or not based on objective criteria which can be applied on a self-assessment basis, that is, without the need for the Commissioner to exercise any discretion; and
- seems both economically appropriate and consistent with the application of the secondary rule.

KPMG Comment: *The application of this rule in New Zealand is unprincipled as:*

— *withholding tax will be paid on the basis that a deduction is available so there is double taxation (unless the hybrid rules apply before the deemed payment for withholding tax applies, but we note the contrary is proposed, see chapter 11);*
— *the treatment of the amount as incurred and deductible is based on principled approaches to the allowance of deductions;*
— *any period is arbitrary if it does not have regard to the commercial terms of the arrangement. For example, commercial loan terms are often structured to match expected cashflows from a project. Such loans should not be subject to the rules.*

Submission points 5C

Submissions are sought on:

- whether the approach recommended by the Australian Board of Taxation would be an acceptable one for New Zealand;
- what alternatives might be better to deal with timing mismatches; and
- what thresholds should apply to determine when the rule would apply to a difference caused by different income and expenditure recognition rules.

Effect of CFC inclusion on application of Recommendation 1

5.46 The need to treat CFC taxation of a payee's owner to be treated as taxation of the payee itself is not pressing in the case of the secondary response. Taxation

of the payee in the payee country under the defensive rule is likely to simply reduce CFC taxation in the owner country.

5.47 Given the complexity of establishing the extent to which taxation under a CFC regime should be treated as inclusion for purposes of the hybrid rules, the fact that there is no need to do so when applying the secondary response, and the fact that there are usually alternatives to the use of hybrid instruments, it is not proposed to treat CFC taxation as relevant in applying Recommendation 1.

> ***KPMG Comment:*** *We consider these proposals are unprincipled. The application of CFC rules in the owner's country will potentially overturn the D/NI conclusion, which justifies the application of the hybrid rules in the first place. If double non-taxation is the true target of the rules, then the rules should only apply if there is in fact double non-taxation.*
>
> *We appreciate the complexity that this might bring but note:*
>
> — *With self-assessment, the onus is on the taxpayer to show that the foreign CFC rules apply to tax the amount;*
> — *A hybrid may correctly prevent double taxation if CFC rules apply;*
> — *Alternatives may be less commercially applicable.*

Submission point 5D

Submissions are sought on whether this approach as to CFC inclusion will give rise to any practical difficulties.

Taxation of FIF interests

5.48 If a New Zealand resident holds shares subject to the FIF regime, and accounts for those shares using the fair dividend rate (*FDR*), cost or deemed rate of return (*DRR*) method, the dividends on those shares are not taxable. Instead the resident returns an amount of deemed income. Dividends are only taxable if the holder uses the comparative value (*CV*) or attributable foreign interest (*AFI*) method (note that when those two methods are being used, if the dividend is deductible in the foreign country it will not be exempt in New Zealand even if the shareholder is a company).

5.49 FIF taxation therefore presents at least two problems for applying Recommendation 1.

- The non-resident payer of a deductible dividend to a New Zealand payee, if resident in a country with the hybrid rules, will not know how a New Zealand taxpayer of ordinary status would treat the dividend, and therefore will not know whether, or to what extent, it is denied a deduction for the dividend by the primary response in its own country.
- When the New Zealand payee is applying the defensive rule (in a case where the non-resident payer of a deductible dividend has not been denied a deduction), if the payee is not applying the CV or AFI method,

the payee will need to determine how much of the dividend has not been taxed, in order to know how much additional income to include.

5.50 Possible solutions are to:

- deny the FDR, cost and DRR methods to shares on which any dividend would be deductible to the payer. This would be similar to the existing requirement to use the CV method for a non-ordinary (generally, debt-like) share (section EX 46(8));
- include a deductible dividend in the holder's income, in addition to income already recognised under the FDR, cost or DRR method. This would be similar to the exclusion of deductible dividends from the general exemption for foreign dividends received by New Zealand companies in section CW 9 (though this exclusion does not apply to interests accounted for under the FDR, DRR or cost method);
- include a deductible dividend in the holder's income only to the extent that it exceeds the income otherwise recognised on the shares. This is somewhat similar to the concept of a top-up amount (defined in section EX 60) that applies when a person uses the DRR method.

5.51 As long as one of these solutions is adopted, there should be no need for a non-resident payer of a deductible dividend to a New Zealand payee to apply the primary response.

<u>KPMG Comment:</u>

<u>Principle</u>

<u>It is not clear why the FIF rules present any hybrid concerns. The FIF rules have been deliberately designed to tax a deemed rate of return as proxy for dividend income (through the FDR regime). This was set at a rate that was expected to exceed the actual dividend yield from overseas investments. The aim was to broadly tax a dividend yield approximating what an Australasian listed stock would pay.</u>

<u>The fact that the FIF rules are a "code" was a deliberate design choice. The FDR method was aimed at broadly aligning with the tax position of a NZ investor in NZ shares. The application of hybrid rules, would result in New Zealand taxing FIF investments more heavily than domestic investments</u>

<u>In our view, Officials should clearly articulate the policy of the FIF rules to support the view that the technical exemption of a dividend from a FIF does not produce a D/NI result. No specific hybrid rule is required.</u>

<u>Breadth of application</u>

<u>We have corresponded with Officials regarding our concerns of the breadth of the definition of structured arrangement (see chapter 12) and its interaction with this analysis. There is a real potential for the hybrid rules to inappropriately override the FIF rules in unrelated scenarios.</u>

This will potentially impact compliance for PIEs and others, including "mum and dad" investors, which rely on the certainty of the FDR method. The latter are likely to be able to apply the hybrid rules in a cost effective way.

Officials should ensure that the rules as they are drafted and are applied (if it proceeds) does not inappropriately override the FDR method.

Submission point 5E

Submissions are sought on which of these FIF approaches would be preferable and why, and whether there is another better approach.

Transfers of assets: revenue account holders

5.52 Recommendation 1 could apply to an asset transfer involving a New Zealand party. For example, suppose a New Zealand resident purchases an asset from a related party on deferred payment terms, and is entitled to deduct a portion of the price as financial arrangement expenditure. If the vendor treats the entire amount as being from the sale of the asset, then there will be a hybrid mismatch, and the purchaser will be denied a deduction for the expenditure.

5.53 The treatment if the New Zealand resident is acquiring the asset on revenue account (for example, because it is a trader), is less clear. As set out above, the Final Report states that where a person is entitled to a deduction for a payment only because the person holds an asset on revenue account, and the person is fully taxable on their economic gain or loss from the asset, that deduction should not be denied by the linking rule.

5.54 However, revenue account holders are not entitled to include in the cost of trading stock the element of their purchase price which is treated as financial arrangement expenditure (section EW 2(2)(d)). The denial of a deduction for that expenditure under the linking rule would not include it in the cost of trading stock. Also, non-taxation of income (for example, dividends on shares accounted for under the FDR method) is not turned off for revenue account holders. So, it is not the case that revenue account holders are always subject to income tax on all of their economic income.

5.55 Given that New Zealand does not tax revenue account holders on the basis referred to in paragraph 52 of the Final Report (referred to above), it is not proposed to exempt revenue account payers from the effect of the hybrid rule.

***KPMG Comment:** We refer to our comments on the FIF analysis above for the comments in 5.54.*

The non-inclusion of financial arrangement expenditure as part of the cost of the trading stock/revenue account property does not justify the application of the rule. The reason that amount is not included in the

cost is to ensure the expenditure is not double counted. It gives priority to the financial arrangement rules for the timing of the deduction. The result of the New Zealand rules is that the full economic gain is taxed albeit at different times.

Put another way, the document's analysis appears to be:

- *New Zealand, on a principled basis, deems an amount to be interest and not the cost of property;*
- *This justifies treating the deemed interest amount as non-deductible.*

This analysis is unprincipled and illogical, in our view. Clearly, revenue account holders should be exempt from the rules.

Submission point 5F

Submissions are sought as to whether revenue account holders should have an exemption from the rules.

Transfers of assets: hybrid transfers

5.56 New Zealand does have some specific tax rules for share loans and repos (the rules applying to returning share transfers and share lending arrangements, both as defined in the Income Tax Act 2007). Generally, these do not treat the share supplier as continuing to own the shares (though there is an exception for returning share transfers when the share supplier uses the FDR method to determine its income from foreign shares).[49] The closest they come is that in relation to a share lending arrangement the share supplier is treated as owning a *share lending right* for the period of the arrangement.

5.57 As referred to above, New Zealand has unique rules relating to the taxation of dividends on foreign shares. While dividends from ASX listed shares are generally taxable, other dividends on foreign shares may or may not be taxable.

5.58 Again, the New Zealand tax regime creates a difficulty for both counterparty countries (in this case, the country where the repo or share loan counterparty is resident, rather than where the share issuer is resident) and for New Zealand. Again, it would be possible to solve these issues by having a rule which would ensure that dividends paid on foreign shares to a New Zealand person who is party to a hybrid transfer with respect to the shares are always taxable, applying one of the approaches referred to in paragraph **Error! Reference source not found.**. The taxation of dividends paid on New Zealand shares held by a New Zealand share receiver who is a party to a hybrid transfer would be unchanged, unless the defensive rule was applied. In that case, the dividends would be taxable with no credit for any imputation credits on the dividends (see Final Report, Example 1.32).

[49] See sections EX 52(14C) and EX 53(16C), Income Tax Act 2007.

KPMG Comment: *It is difficult to follow what exactly is proposed in this section. To the extent it relies on the earlier analysis for FIF investments, the same comments as above apply.*

Submission point 5G

Submissions are sought on whether this proposal for amending the income tax treatment of a New Zealand resident who holds shares subject to a hybrid transfer would be a practical response.

Regulatory capital

5.59 The UK proposes to take up the option to exclude bank regulatory capital instruments from its regime in certain circumstances (see discussion at Chapter 8 of *Tackling aggressive tax planning* (HM Treasury and HMRC, December 2014). However, we understand that the UK has existing anti-hybrid rules that apply to bank regulatory capital. The Australian Board of Taxation Report sought an extension of time to report on this issue.

5.60 It is not proposed that bank regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

KPMG Comment: *See the comments above regarding the likely increased cost to New Zealand of applying the hybrid rules to bank regulatory capital. This is due to the likely lower rate that applies to hybrid capital and that its replacement would be debt and not equity for the New Zealand branch.*

At a minimum, implementation of the hybrid rules should be deferred until Australia decides on its approach and its rules are confirmed. Australia's approach may make any inclusion of bank regulatory capital moot.

Submission point 5H

Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital.

5.61 The exemption of an instrument from the hybrid rules in one country does not require exemption of that same instrument by others (Final Report, page 11). A decision by a country not to fully implement the rules is not intended to bind other countries in their own implementation. That is true even in an area where non-implementation is an option provided by the Final Report. Whether it is

intended or not, a hybrid mismatch causes the same loss of overall tax revenue, and gives rise to the same difficulties of attributing that loss.

Other exclusions

5.62 We note that the UK legislation proposes an exception for hybrid transfers to which a financial trader is a party (section 259DD).[50] The Board of Taxation has recommended that consideration be given to an exception for financial traders entering into repos and securities-lending agreements. It is not clear that sufficient activity of this kind is taking place to justify an exception of this kind in New Zealand.

> **Submission point 5I**
>
> Submissions are sought on whether such an exception is necessary or desirable, and how it should be designed.

5.63 New Zealand does not seem to have any entities requiring an exception under Recommendation 1.5 from the primary response. In particular, PIEs are not entitled to a deduction for their distributions, and are not required to distribute their income within any period.

> ***KPMG Comment**: New Zealand investors will invest in foreign PIE equivalents who may be seen to have a deduction for distributions made to an investor. We refer particularly to Australian Unit Trusts. From a New Zealand perspective, the Australian entity pays no tax due to it distributing (by the vesting income in beneficiary rules) to investors who are taxed or not.*
>
> *Investments in such vehicles should be explicitly excluded from the secondary response.*

> **Submission point 5J**
>
> Submissions are sought on whether there are any other New Zealand entities that should be eligible for this exemption.

5.64 Finally, although the main target of the rule is cross-border transactions, the OECD recommendations can also apply to payments within a country (see Final Report, Examples 1.13 and 1.21). This means that the hybrid financial arrangement rule might deny deductions in purely domestic transactions in some circumstances. However, the focus of the hybrid mismatch rules should

[50] Section 259DD of Schedule 10 of the Finance (No.2) Bill (United Kingdom).

be on cross-border activity and accordingly it is proposed that domestic transactions are specifically excluded from the application of the rules.

KPMG Comment: *We agree.*

CHAPTER 6

Disregarded hybrid payments

6.1 This chapter considers Recommendation 3 of the Final Report; the disregarded hybrid payments rule. The rule applies when a deductible cross-border payment has been disregarded by the payee country due to that country's treatment of the payer. This generally results in a D/NI outcome. This outcome can be counteracted by the disregarded hybrid payments rule through a denial of deduction in the payer country (the primary response), or an inclusion of income in the payee country (the secondary response or defensive measure).

6.2 The disregarded hybrid payments rule only applies if the parties to the hybrid mismatch are in the same control group or are party to a structured arrangement (both defined in Chapter 12).

6.3 Figure 2.3 in Chapter 2 of this document is an example of a disregarded hybrid payment structure.

Requirements for rule to apply

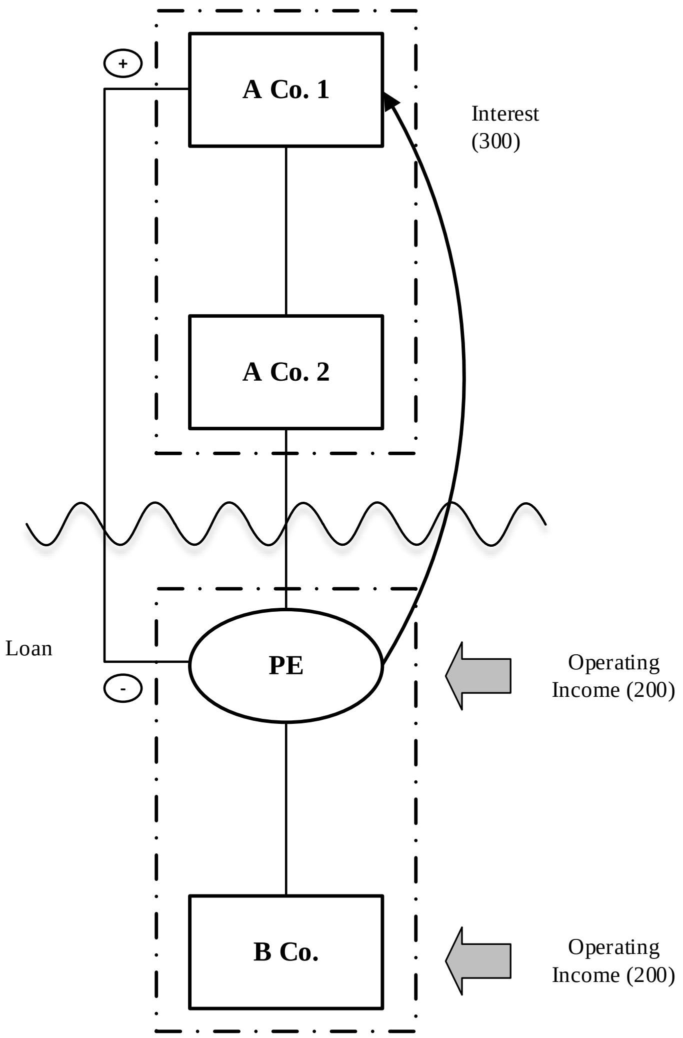
6.4 A disregarded payment is one that is deductible in a country where the payer is a taxpayer (the payer country) and is not recognised as a payment in any country in which the payee is a taxpayer (the payee country).

6.5 A hybrid payer is an entity that is treated by the payee country in a manner that results in a payment by the entity being disregarded.

6.6 An example of a hybrid payer entity in New Zealand is an unlimited liability company wholly owned by a US parent. The company is fiscally opaque in New Zealand but treated as a foreign branch of the US parent in the US. Accordingly when it makes a payment to its parent, there is a deduction in New Zealand but no inclusion in the US.

6.7 The question of whether an entity is a hybrid payer will not turn on a preordained list of entities and no characteristics in and of themselves would qualify an entity as a hybrid payer. Moreover, an entity that is considered to be a hybrid payer in one scenario may not be a hybrid payer under a different scenario. See for instance, Example 3.2 of the Final Report, reproduced below as Figure 6.1.

Figure 6.1: Disregarded hybrid payment using consolidation regime and tax grouping[51]



6.8 In this case, the election by A Co 1 and A Co 2 to consolidate for tax purposes results in a disregarded payment and the classification of A Co 2 as a hybrid payer. It is the fact of consolidation rather than the particular characteristics of A Co 2 that mean that the company is a hybrid payer.

6.9 It is possible for a disregarded payment to arise as a result of a deemed payment between a branch and another part of the same legal entity. In some countries, if funds or an asset, attributable to a foreign entity's operations in a foreign country is provided to a domestic branch of the same legal entity, the domestic branch is entitled to a deduction for a notional payment for the provision of the funds or asset. If the foreign country does not recognise this payment, there is a disregarded payment.

Dual inclusion income

6.10 The disregarded hybrid payment rule will not apply to the extent that the payer's deduction is offset against income that is dual inclusion income.

[51] OECD 2015 Final Report, Example 3.2, at p293.

6.11 Dual inclusion income is ordinary taxable income in the payer country and in the payee country. Dual inclusion income is also relevant to the deductible hybrid payments rule and to the double deduction and dual resident payer rules which are discussed in Chapters 8 and 9 respectively.

6.12 The exclusion from the rule for disregarded payments offset by the payer against dual inclusion income recognises that a taxpayer's circumstances may create a tax advantage through a disregarded payment in the payer country which is neutralised by taxation in the payee country. The advantage is neutralised because the payee country taxes the dual inclusion income with no deduction for the disregarded payment.

6.13 Differences in the way that each country treats income in terms of timing or valuation will not prevent the classification of an item of income as dual inclusion income. This is demonstrated in Example 6.1 of the Final Report. In that example, different timing rules apply in the payer and parent countries to the calculation of dual inclusion income, which means that different amounts are affected by the hybrid rule depending on whether the primary or defensive rule applies. The payer country's calculation of the dual inclusion income is used to make the primary response whereas the payee country's calculation would be used to make the defensive response.

6.14 The Final Report recommends that items that are taxed as income in one country and are subject to a type of double taxation relief in the other country can nonetheless be classified as dual inclusion income.[52] Dual inclusion income includes an equity return that is:

- taxable in the payee country (whether or not with an underlying foreign tax credit); and
- granted a tax credit or exemption in the payer country, which is designed to avoid economic taxation.

6.15 An example of dual inclusion income that is subject to double taxation relief in one country is Example 6.3 of the Final Report. In that example, a dividend received by a hybrid payer is allowed an intra-group tax exemption in the payer country but is subject to tax in the payee country due to the dividend recipient (hybrid payer) being treated as fiscally transparent in the payee country.

6.16 A further example of dual inclusion income is if B Sub 1 in Figure 2.3/6.1 pays an exempt or fully imputed dividend to B Co, provided that dividend is subject to tax in Country A.

6.17 Broadly speaking, the effect of allowing a D/NI payment to be deducted against dual inclusion income but then applying Recommendation 3 as to any excess is that to the extent of the D/NI payment, any net loss incurred by or through the hybrid entity:

[52] OECD 2015 Final Report at para 126.

- is unable to be used to offset any other income in the payer country (primary rule); or
- is unable to be used to offset any other income in the payee country.

The qualification to that statement is that it is only entirely true if all of the income derived by or through the payer entity is dual inclusion income. If some of it is not dual inclusion income, the amount of the D/NI payment that may not be deducted will be increased by that amount.

Example

Take the example in Figure 2.3/6.1. Suppose that the interest payment to A Co is $300, and that in addition, B Co has $50 of income and B Sub 1 has $100 of net income. The $50 income earned by B Co would *prima facie* be taxable also to A Co, and is therefore dual inclusion income. The $100 earned by B Sub 1 would not be taxable to A Co and therefore would not be dual inclusion income.

Accordingly, under the primary rule, Country B would deny B Co a deduction for $250 of the interest. B Co would have no net income or loss, and B Sub 1 would have $100 income. A Co would have $50 income.

Under the defensive rule, Country A would tax A Co on $250 of interest. The result of the defensive rule would be a loss in Country B of $150 (after offset of $100 of B Co's $250 loss against B Sub 1's income), and income for A Co in Country A of $300 (the $50 of income earned by B Co plus $250 under the Recommendation 3 defensive rule).

Carry-forward of denied deductions

6.18 Any deduction denied under the disregarded hybrid payments primary rule may be carried forward to a future year to be offset against excess dual inclusion income (that is, dual inclusion income against which a hybrid deduction has not already been taken).

6.19 Carry-forward would be subject to the existing continuity of ownership rule that applies to the carry-forward of losses.

Example

Take the example above. Suppose the only event in year 2 is that B Sub 1 pays a dividend to B Co of $100, which is exempt to B Co in Country B but taxable to A Co in Country A. The dividend is dual inclusion income. If the primary rule applied in year 1, in year 2 $100 of the $250 portion of the interest deduction disallowed in year 1 under the primary rule would be deductible to B Co in year 2, giving it a net loss of $100 in Country B, which it is free to use in accordance with Country B tax rules (for example, it can be grouped with the income of another group member).

However, if the defensive rule applied in year 1, the Final Report does not provide for reversal of the $250 income recognised by A Co.

Submission point 6A

Submissions are sought on whether there are any issues with using the rules for the carrying forward of tax losses as a basis for the treatment of carrying forward disallowed deductions.

KPMG Comment: *The effect of denying the deduction is to treat the expenditure as not incurred or to match that expense against the income that it generates. If the denial of the deduction is principled, there is no reason to subject the expense to a carry-forward rule. It will be properly deducted against the income that it generates. To deny a deduction would be to over-tax when there is no net income to tax.*

Application of CFC regimes

6.20 The Final Report states (paragraph 127) that an item of income can be dual inclusion income if it is the ordinary income of a company subject to tax in one country and is attributed income for the shareholder of the company in another country under a CFC regime. The Final Report recommends that for a taxpayer to claim an item of income to be dual inclusion income, they must demonstrate to the relevant tax authority that the effect of the CFC regime is that the item of income is subjected to full rates of tax in two countries.

Implementation issues

6.21 To calculate its dual inclusion income, a taxpayer must detect all instances where two countries will consider the same item to be included as income. This task could involve substantial compliance costs where a taxpayer has many cross-border payments and where payments are recognised in different ways by the countries. The Final Report suggests that countries should aim to introduce implementation solutions that maintain the policy intent of the rules while reducing the compliance costs that taxpayers may encounter in assessing their dual inclusion income.[53]

6.22 Taxpayers generally prepare accounts of income and expenditure in the countries they operate in. This information could be used as an initial basis for identifying dual inclusion income. A document containing this information with identified dual inclusion income items should be maintained by the taxpayer to support the claiming of a deduction for a D/NI payment (and, if the payer country does not apply the primary rule, non-inclusion of such a payment under the secondary rule).

6.23 The Final Report proposes[54] that, to apply the disregarded hybrid payments rule primary response, the total claimed deductions for disregarded payments would be limited to the extent of the total identified dual inclusion income of the taxpayer. The defensive response would be achieved by requiring payee country entities to recognise income to the extent that deductions claimed in the payer country exceed dual inclusion income.

[53] At para 130.
[54] Example 3.1; paras 13–14.

6.24 Another implementation solution suggested by the Final Report (Example 3.2, reproduced in Figure 6.1) is in relation to a consolidated group that crosses two countries (for example, where a member has a branch in another jurisdiction, or where a member is a resident of another jurisdiction). The Final Report proposes that in applying the primary response the payer country could prevent a hybrid payer from using a loss of the payer country consolidated group to the extent that deductions have been claimed in the payer country for payments that were disregarded under the law of the payee country. For the defensive response, the payee country would require a resident entity to include as income the hybrid payer's deductible payments that are disregarded in the payee country to the extent that they result in a net loss (taking into account dual inclusion income) in the payer country. The Final Report further suggests that specific measures would be needed to ensure that the parties involved in a transaction cannot circumvent these rules by allocating non-dual inclusion income to the hybrid payer in order to offset its losses.

KPMG Comment: *The principled response is to allow taxpayers to show that income is dual inclusion. In New Zealand's self-assessment regime that would be required in any case.*

We would also expect that if existing systems do not already track material amounts that such systems would be developed. This would potentially be in conjunction with systems developed to comply with CbC reporting requirements.

We note that if such evidence is not available a deduction would be denied.

Submission point 6B

Submissions are sought on the practicalities of assessing a taxpayer's dual inclusion income, the feasibility of the implementation options described above, as well as any other implementation solutions for the successful operation of dual inclusion income rules in New Zealand.

Application to New Zealand

Carry-forward/reversal of defensive rule income

6.25 The Final Report does not propose a carry-forward rule for the application of the defensive rule. This creates a potential for over-taxation in a scenario where the defensive rule is applied to include extra income in the payee country and excess dual inclusion income arises in a later year.

6.26 A solution to this problem may be to provide for a "reversal" rule whereby the application of the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income.

6.27 Alternatively, the defensive rule could be limited so that income is only included to the extent that the disregarded payment deduction is offset against non-dual inclusion income in the payer jurisdiction. In the event that there is no non-dual inclusion income that the payment can be offset against, the income inclusion could be suspended until non-dual inclusion income is present. Unlike the reversal approach, this option would require the payee country tax authority and payee jurisdiction taxpayers to be aware of the level of non-dual inclusion income being earned in the payer country.

> ***KPMG Comment****: The reversal rule appears easier to apply, subject to the comments above regarding continuity rules.*
>
> *We note that it is not clear what 6.27 actually proposes.*

Submission point 6C

Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in this regard, and which approach would be best to take.

Dual inclusion income

6.28 As with Recommendation 1, it is proposed that CFC income is not able to be included as dual inclusion income. This will avoid drafting a large amount of very detailed and targeted legislation, aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise.

> ***KPMG Comment:*** *See our comments above. We consider this proposal unprincipled as it does not attempt to prevent double taxation. CFC income should be able to be included as dual inclusion income.*
>
> *We agree that the legislation is likely to be complex to be appropriately targeted. The rules should be as clear as possible. Therefore, their implementation may also justify a consolidation and re-write of the CFC and FIF rules which the Finance and Expenditure Select Committee has already recommended.*

Submission point 6D

Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in relation to CFC income as dual inclusion income.

CHAPTER 7

Reverse hybrids

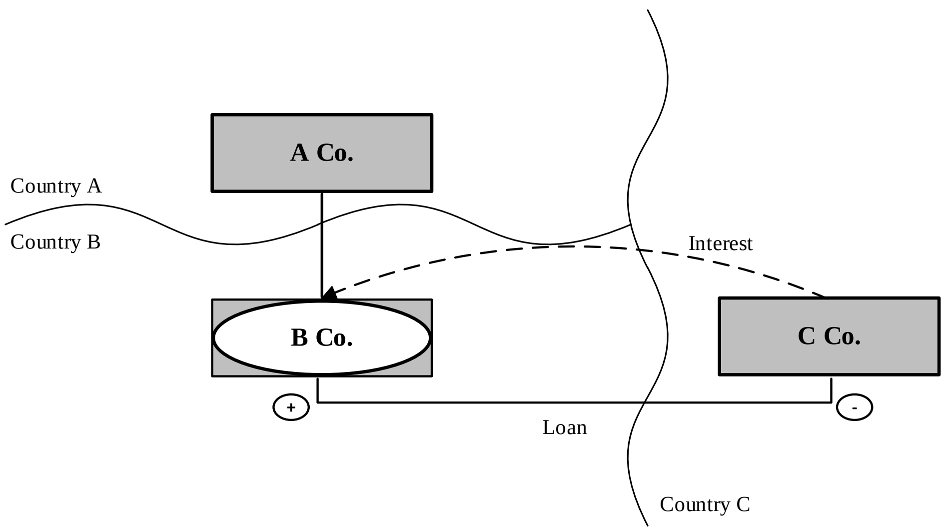
7.1 A reverse hybrid is an entity where some or all of whose income is (or can be):

- in its establishment country, treated as derived by its investors (generally its owners); and
- in an investor country, treated as derived by the entity.

7.2 A New Zealand limited partnership may be an example of such an entity. For New Zealand tax purposes, the income of a New Zealand limited partnership is taxable to the partners. However, if a partner is resident in a country that treats the partnership as an entity separate from the partners for its tax purposes (for example, because it has separate legal personality) the partnership is to that extent a reverse hybrid. Look-through companies can also be reverse hybrid vehicles in New Zealand (though recent proposed law changes will limit the ability for conduit income to be earned through a look-through company). A New Zealand trust may also be a reverse hybrid. For New Zealand tax purposes, income which is treated as beneficiary income is taxed to the beneficiary, not the trustee. However, if the beneficiary is resident in a country which does not recognise trusts, the income may not be treated by the beneficiary's residence country as derived by the beneficiary, particularly if it is not actually distributed to the beneficiary.

7.3 An example of a reverse hybrid giving rise to a hybrid mismatch is in Figure 2.5 (repeated below from Chapter 2).

Figure 7.1: Payment to a reverse hybrid (repeated Figure 2.5)



Branches as reverse hybrids

7.4 When a country does not tax its residents on income from foreign branches, a mismatch of rules between that country and the country where a branch is located can lead to a reverse hybrid result. This can occur if a payment to a person is treated in the residence country as non-taxable because it is attributed to a foreign branch, but in the branch country the payment is also not taxed, because the branch country either:

- does not treat the person as having a branch; or
- treats the payment as not attributable to the branch.

7.5 Accordingly, Recommendations 4 and 5 are also applicable to branches in these situations. The branch is analogous to the reverse hybrid entity, and the head office to the investor.

Recommendation 4

7.6 Recommendation 4 is when a D/NI payment is made to a reverse hybrid, and the payment would have been included in income if it were made directly to the investor; the payer country should deny a deduction for the payment. The Recommendation also applies if the payment would have given rise to a hybrid mismatch under the hybrid financial instrument rule if made directly to the investor. As with the disregarded payments rule, this rule can apply to any deductible payment.

7.7 Taxation of an investor in its home country on a subsequent distribution by the reverse hybrid of the income does not prevent a payment being subject to disallowance under this Recommendation (Final Report, paragraph 156).

7.8 Many trusts – for example, most family trusts, do not have investors as such. For the purposes of this rule, an investor is any person to whom income is allocated by a reverse hybrid. So it would include any person who is allocated beneficiary income.

7.9 The Recommendation will not apply if the reverse hybrid establishment country taxes as ordinary income the income allocated to the non-resident investor – for example, on the basis that the reverse hybrid is carrying on business in the establishment country.

7.10 The rule only applies if either:

- the investor, the reverse hybrid and the payer are members of the same control group; or
- the payment is under a structured arrangement to which the payer is a party.

7.11 The definitions of a control group and a structured arrangement are in Chapter 12.

7.12 There is no defensive rule for reverse hybrids. This is on the basis that if a country adopts Recommendation 5, there is no need for a defensive rule.

Recommendation 5

7.13 Recommendation 5 contains three further recommendations regarding tax rules for reverse hybrids as follows:

- Countries should ensure that their CFC and other offshore investment regimes are effective to prevent D/NI outcomes arising in respect of payments to a reverse hybrid in which their residents are investors.
- Countries should tax reverse hybrids established in their own country to the extent that their income is allocated to non-residents who are not taxable on the income because they are resident in a country that treats the reverse hybrid as fiscally opaque. This recommendation would only apply if the non-resident investor is in the same control group as the reverse hybrid.
- Countries should introduce appropriate tax filing and information reporting requirements on tax transparent entities established within their country in order to assist non-residents and tax administrations to determine how much income has been attributed to their investors.

7.14 The proposed application of Recommendations 4 and 5 in New Zealand is considered below.

Application in New Zealand

Recommendation 4

7.15 From a New Zealand perspective, it will be New Zealand payers rather than New Zealand payees who are affected by New Zealand legislating for this recommendation. There do not seem to be any particular New Zealand-specific issues raised by Recommendation 4 that have not already been discussed in relation to the other Recommendations. Implementing the rule will simply involve denying a deduction if the necessary conditions are satisfied.

KPMG Comment: *As above generally and relevant.*

Submission point 7A

Submissions are sought on whether there are any issues relating to implementing Recommendation 4 in New Zealand.

7.16 From the perspective of other jurisdictions making payments to New Zealand, we note that a foreign investor PIE would seem to be a reverse hybrid, depending on the treatment of the investors in their home countries (see Final Report, paragraphs 161 and 162). However, a payment to a foreign investor PIE would not be subject to disallowance in most cases, due to the scope limitation of Recommendation 4.

KPMG Comment: *This conclusion seems to be contrary to the comment above regarding deductions for PIEs. It also ignores the technical answer that the PIE is in fact taxable on the payment made, it is simply taxed at a "nil" rate. This is a specific policy decision. It highlights the need to determine whether the result is a hybrid outcome or a deliberate "exemption". The foreign investor is not taxed or looked through to under the New Zealand tax rules.*

We refer above to our concerns regarding the scope of the structured arrangement definition. We consider that the last sentence is not clearly correct.

Recommendation 5.1: CFC and other offshore investment regimes

7.17 This recommendation is for New Zealand to ensure that a payment to a CFC that is fiscally transparent in its establishment country with respect to the payment is caught by the CFC regime, that is, that it is taxed to New Zealand investors in the CFC, if those investors are subject to tax under the CFC regime. In this way, the CFC regime would be used to turn the reverse hybrid into an ordinary fiscally transparent entity, at least insofar as it allocates income to New Zealand investors.

7.18 One way to address this would be to treat any person who has an interest in a CFC, as determined under subpart EX, to derive an amount of income from the CFC equal to the amount allocated to that person by the reverse hybrid for income tax purposes in its establishment country, and which is not taxed in the establishment country because of that allocation. This figure will already have been calculated by the CFC, and so should be readily available to the investor. In the case of an entity that is only partially transparent only the untaxed income would be subject to the CFC regime.

7.19 This is the approach suggested in paragraph 173 of the Final Report. It would override the rules which generally apply to the calculation of CFC income. In particular:

- attribution would not be limited to the types of income specified in section EX 20B, being generally passive or base company income;
- the exemption for non-attributing Australian CFCs would have to be amended such that reverse hybrid entities established in Australia would be excluded from the exemption;
- the amount of income taxable in New Zealand would be determined under the tax rules of the establishment country, rather than under New Zealand tax rules. This is different from the approach taken for foreign entities which New Zealand treats as fiscally transparent – for example,

foreign general partnerships. An investor's taxable income in such entities must be calculated under New Zealand income tax rules. While this ensures that income from foreign sources is determined in the same way as income from domestic sources, it does require an additional element of compliance, and can lead to either double taxation or double non-taxation, either on a temporary or permanent basis; and

- the amount allocated to an investor would not be determined by reference to the investor's income interest as calculated under New Zealand tax rules, but by reference to the investor's percentage share of the entity's income as determined by the rules of the establishment country (though the two would usually be the same or very similar).

KPMG Comment: *This section does not clearly detail the interaction with the active income exemption. It appears to suggest that the active income exemption would be overridden if the CFC's income is attributed to the New Zealand investor. It is not clear why such an override is required (given that it would not be taxed in New Zealand).*

7.20 This recommendation would also apply to the attributable foreign income method under the foreign investment fund (FIF) regime. It would not seem necessary to apply it in relation to the other FIF methods, which already tax on an accrual basis. While there are certain exemptions from the FIF regime, these do not seem to be available to a reverse hybrid, because all of them require that the non-FIF entity is liable to tax either in Australia or in a grey list country. This requirement might need to be modified to ensure that the exemptions are not available to partially transparent entities.

7.21 Trusts established in a foreign jurisdiction with a New Zealand resident settlor are already fully taxable, that is, it is not possible for such a trust to be a reverse hybrid. However, if a payment received by a foreign or non-qualifying trust which has foreign trustees is:

- attributed to a New Zealand beneficiary under the laws of that foreign country and therefore not taxed in that country; and
- not taxed by New Zealand, for example, because it is treated by New Zealand as trustee income that is not subject to New Zealand tax, the foreign trust is to that extent a reverse hybrid.

KPMG Comment: *It is not clear that this can be achieved under New Zealand's trust laws. New Zealand treats an amount as beneficiary income if it was paid or applied to the beneficiary. It is not clear what foreign rule would be broader than this rule so that it was treated as beneficiary and not trustee income. (We would expect the reverse to apply.) Further, if there were such a gap, the payment when made to the beneficiary, as sourced from trustee income, would be a taxable distribution. The document's concern seems to be theoretical.*

7.22 The mismatch could be resolved by treating such a payment as beneficiary income for New Zealand tax purposes. This should not be problematic from an administrative perspective, since the records of the trust in the establishment country would generally reflect in some way the allocation of the income to the beneficiary.

7.23 Alternatively, New Zealand could depart from the OECD's approach and achieve the intention of Recommendation 5.1 through a different type of rule.

7.24 The UK has drafted a narrower rule than that in Recommendation 5.1. Its rule includes an amount in the income of a UK investor which is derived through a reverse hybrid only to the extent of a D/NI mismatch in respect of a payment to the reverse hybrid that is not counteracted in another jurisdiction.[55] This rule resembles the "defensive" parts of other OECD recommendations, such as the hybrid financial instrument rule (Recommendation 1) and the disregarded hybrid payments rule (Recommendation 3). However, this rule is more complex in that it requires the investor to determine whether or not a particular payment has given rise to a D/NI outcome and whether or not that has already been counteracted.

7.25 Australia already has a set of rules that seek to counteract mismatches arising from reverse hybrid entities established in other countries.[56] These rules provide that a specified list of foreign entities are treated as partnerships under Australian law to the extent that they are tax-transparent in their establishment jurisdiction. The rules therefore link the tax treatment in Australia to the overseas tax treatment and ensures that the untaxed income of the foreign entity will flow through to its Australian investors on an apportioned basis.

> ***KPMG Comment:*** *Consistent with our view, this appears to be a more principled approach as it goes part way to aligning definitions of opaque/transparent treatment of entities.*
>
> *However, we note the difficulty with this approach is that it imports definitions without subjecting them to the consultative process.*
>
> *We consider a better approach would be to agree with Australia a common definition of opaque/transparent entities which could be included in New Zealand's domestic law.*

7.26 New Zealand taxes residents on the income they derive through foreign branches, so Recommendation 5.1 does not require any change in that respect.

> ***KPMG Comment:*** *The document does not appear to have any regard to the questions that arise in chapter 8 for foreign branches. It supports our view that the proposals, because of their breadth and the lack of co-ordination, risks creating an incoherent New Zealand tax regime.*

[55] Section 259GD, Schedule 10, Finance (No. 2) Bill 2016.
[56] Division 830, Income Tax Assessment Act 1997.

Submission points 7B

Submissions are sought on whether it would be best for New Zealand to:

- follow the OECD's Recommendation 5.1 and amend its CFC rules as discussed above; or
- adopt a more limited approach as in the UK; or
- link the New Zealand tax treatment of income earned through a foreign entity to the treatment in the jurisdiction where that entity is established, as Australia has done on a limited basis.

If the OECD approach is to be followed, how could New Zealand's CFC regime best be adapted to impose New Zealand tax on income allocated to a New Zealand resident by a reverse hybrid?

Submissions are also sought on the desirability or otherwise of changes to New Zealand's trust and FIF regimes for the purpose of implementing Recommendation 5.1.

Recommendation 5.2: Taxation of reverse hybrids established in New Zealand

7.27 Under this rule New Zealand would tax the foreign source income of (for example) a New Zealand partnership as if it were a company, to the extent that income is allocated to a non-resident 50 percent partner who treats the partnership as fiscally opaque. The ownership threshold is necessary to the example because the scope of the recommendation is limited to investors who are in the same control group as the reverse hybrid. If New Zealand turned off its transparency in this kind of case, neither payer nor investor country would need to apply their reverse hybrid rule to that payment. This approach would also apply to payments that are not deductible (and therefore not subject to Recommendations 4 or 5.1). A dividend paid by a foreign company to a New Zealand partnership with a majority foreign owner who treats the partnership as exempt would be subject to New Zealand tax on the same basis as if the partnership were a company.

7.28 This rule could apply to limited and general partnerships, and to foreign investor PIEs, to the extent those entities derive foreign sourced income which is allocated to foreign investors. It could also apply to a New Zealand foreign trust (a trust with a New Zealand trustee but no New Zealand settlor, and usually no New Zealand assets), to the extent that the trust allocates foreign income as beneficiary income to a non-resident beneficiary in the same control group as the trust.

7.29 There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand's right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply

Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.

7.30 The definition of a "control group" is discussed in more detail in Chapter 12. The definition is designed to apply to partnerships and trusts as well as to corporate groups. Example 11.1 of the Final Report demonstrates that:

- the power to appoint a trustee of a trust is treated as a voting interest in the trust;
- where a settlor's immediate family are the beneficiaries of a trust, they will be treated as holding equity interests in the trust, and these equity interests will be deemed held by the settlor under the "acting together" test.

7.31 This rule also suggests that New Zealand should tax the non-New Zealand source income of a non-resident if the non-resident's home country:

- treats the income as attributable to a New Zealand branch; and
- on that basis, exempts it from tax.

KPMG Comment: *The treatment of a foreign trust has been recently considered by the Independent Review of New Zealand foreign trusts. It concluded that New Zealand's principled approach is correct. We see no reason to depart from that conclusion.*

We further note that a "New Zealand foreign trust" is not defined. See our submissions on the Taxation (Business Taxation, Exchange of Information and Remedial Matters,) Bill. The scope of this change is potentially significant.

Submission points 7D

Submissions are sought on whether and to what extent reverse hybrid entities established in New Zealand should (or should not) become taxable on their income under the principle of Recommendation 5.2. In particular, should trustee income earned by a New Zealand foreign trust be subject to New Zealand tax if the requirements of Recommendation 5.2 are met?

Submissions are also sought on the proposal to tax income treated by another jurisdiction as attributable to a New Zealand branch, and accordingly not subject to tax, as taxable in New Zealand, even if it otherwise would not be.

KPMG Comment: *There does not appear to be any detailed discussion of the latter proposal?*

Recommendation 5.3: Information reporting

7.32 Recommendation 5.3 is that countries should have appropriate reporting and filing requirements for tax transparent entities established in their country. This involves the maintenance by such entities of accurate records of:

- the identity of the investors (including trust beneficiaries);
- how much of an investment each investor holds; and
- how much income and expenditure is allocated to each investor.

7.33 Recommendation 5.3 states that this information should be made available on request to both investors and the tax administration.

7.34 Naturally, New Zealand's record-keeping and reporting requirements are focussed on ensuring compliance with the obligation to pay New Zealand tax. They are not generally designed to provide information regarding the derivation of income that New Zealand does not tax. However, the requirements vary. Taking the simple example of a tax transparent entity which is established under New Zealand law but has no New Zealand owners or assets:

- For a general and a limited partnership, there is a requirement to file an IR7 and also an IR7P. The IR7 requires overseas income to be recorded, and the IR7P requires the partners to be identified and the allocation of income to them. This seems to satisfy the requirements of Recommendation 5.3.
- A look-through company is subject to the same record keeping and return filing requirements as a New Zealand partnership. It also must allocate its income and deductions between its owners (Tax Administration Act, section 42B(2)).
- For a New Zealand foreign trust (one where the settlor is not New Zealand resident), the trust is required to keep records allowing the Commissioner to determine its financial position (Tax Administration Act, section 22(2)(fb) and (m). It must keep records of settlements made on and distributions made by the trust. It is also required to keep particulars of the identity of the settlor and distributees, if known (Tax Administration Act, section 22(7)). The trust also has to provide the identifying particulars of the trust and the address of the New Zealand resident trustees (Tax Administration Act, section 59B). There does not seem to be any requirement for the trust to file a tax return if it has no New Zealand source income.
- For a foreign investor PIE, a return must be filed in the prescribed form (TAA section 57B). In order for foreign investors to not be subject to New Zealand tax at 33% (***KPMG Comment:** Note should be 28%?)* on the PIE's foreign income, they must provide to the PIE their name, date of birth, home address, and tax file number in their home country and New Zealand (Tax Administration Act, section 28D).

7.35 With the exception of trusts, New Zealand seems to already be compliant with Recommendation 5.3. The record-keeping and disclosure requirements for New Zealand foreign trusts was separately dealt with by the Government Inquiry into Foreign Trust Disclosure Rules, released on 27 June 2016.[57]

KPMG Comment: *We can see no justification for further changes beyond those already proposed for foreign trusts and by the application of the Automatic Exchange of Information rules for investors generally.*

[57] http://www.treasury.govt.nz/publications/reviews-consultation/foreign-trust-disclosure-rules

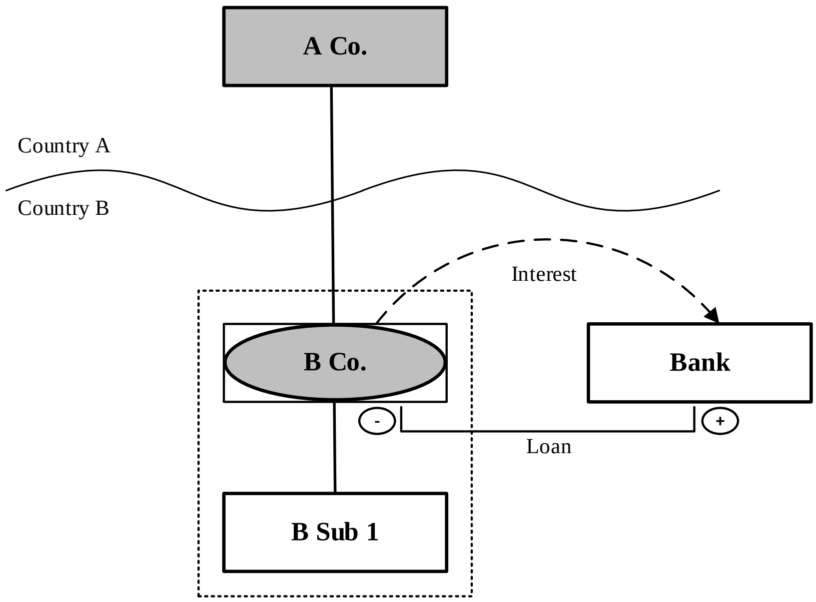
CHAPTER 8

Deductible hybrid payments

8.1 Recommendation 6 concerns payments that are deductible in two countries. A simple example is a payment made by a company's foreign branch. If the company is resident in a country that, like New Zealand, taxes foreign branch income, this payment will often be deductible both in the branch country and in the residence country. The same outcome arises if expenditure is incurred by an entity which is fiscally transparent in a country where one or more of its owners is resident (such as a New Zealand unlimited liability company with a US owner).

8.2 To the extent that such a payment is deducted in one country against income that is not taxed in the other country, the payment produces double non-taxation. This is shown in Figure 2.4, reproduced below.

Figure 8.1: DD arrangement using hybrid entity (repeated Figure 2.4)



8.3 The primary response in Recommendation 6 is for the parent country to deny a deduction for the payment, to the extent it exceeds dual inclusion income (income taxed in both countries). The parent country is the country where the payer is resident (in the case of a branch), or where an owner of the payer is resident (in the case of a hybrid entity). There is no limitation on the scope of this rule.

8.4 The secondary response (which applies only to deductions that are not subject to the primary response) is for the payer country to deny a deduction for the payment, to the extent it exceeds dual inclusion income. The defensive rule applies only if either the payer is a branch, the owner and the payer are in a control group, or the payer is party to a structured arrangement.

8.5 Where a foreign tax credit is available in the parent jurisdiction in relation to an item of dual inclusion income, the Final Report proposes that the foreign tax credit can only be used to the extent of the tax liability in the parent jurisdiction on the net dual inclusion income (dual inclusion income less deductions) that arises. This is discussed in Example 6.4 of the Final Report, in particular paragraphs 13 and 14.

Application to New Zealand

8.6 The primary response means that in most cases a New Zealand resident will not be able to claim an immediate deduction for a foreign branch loss except against income from the same country. This is because in most cases it will be possible for those losses to be used to offset non dual-inclusion income in the branch country. Unless it can be shown that such an offset is not possible, those losses will have to be carried forward and used either:

- to offset net income from the branch in future years;
- without restriction, if the losses have become unusable in the branch country, for instance because the branch has been closed down before the losses have been used or because of an ownership change. In this case the losses are referred to as “stranded losses”.

8.7 This denial extends to all forms of deductions – for example, it applies to depreciation and amortisation (Final Report, paragraph 192). It only applies to expenditure which is actually deductible. Thus, it will not apply to expenditure for which a deduction is denied under (for example) Recommendation 1 or Recommendation 4.

8.8 The secondary response will require New Zealand to introduce a rule denying both New Zealand branches of non-residents and non-resident owned New Zealand hybrid entities the ability to deduct expenditure against income which is not also taxable in the parent country, if that expenditure is not subject to the primary response in the parent country. Most obviously, this will deny such branches or entities the ability to group a loss against the profit of a commonly owned New Zealand entity (unless that entity is also a hybrid whose income is taxable in the parent country). It will also deny them a deduction for their expenditure against their own income if that income is for some reason not taxed in the parent country. An example is income earned through a reverse hybrid (see Example 6.1 of the Final Report).

8.9 As discussed in paragraph 200 and Example 6.5 of the Final Report, where the secondary response applies but the owner who is claiming a deduction in the parent country does not own all of the payer, the hybrid rules require the inclusion, in the payer country, of more than the amount which is deductible in both countries. This is necessary so that the amount of additional income allocated to that owner is sufficient to reverse the deduction.

KPMG Comment:

Foreign branch

There is merit in considering an exemption for active income of a foreign branch. We note that this has been on New Zealand's tax policy agenda for some time but has not been progressed.

It has the advantage of equalising the treatment of a CFC and a foreign branch.

We further note that it may eliminate the need for the proposals in chapter 7.

Amount denied

The comments at paragraph 200 and the example at 6.5 are not clear.

Submission points 8

Submissions are sought on whether the denial of a deduction for foreign branch losses against New Zealand income should be matched by an exemption for active income earned through a foreign branch. This would put foreign branches of New Zealand companies in a similar New Zealand tax position to foreign subsidiaries.

Submissions are also sought on any other aspect of the proposals relating to implementation of the OECD's Recommendation 6 in New Zealand.

CHAPTER 9

Dual resident payers

9.1 Recommendation 7 applies to dual resident entities. It is similar to Recommendation 6, in that it deals with a situation where a single payment is deductible in two countries. However, in this case there is only one entity involved, and both countries regard it as a resident. Since it is not easy to differentiate between the two countries, Recommendation 7.1 is for both countries to deny the deduction to the extent that it is offset against non-dual inclusion income. As with Recommendation 6, any deduction that is disallowed can be offset against dual inclusion income arising in a later period.

9.2 Since only one taxpayer is involved, there is no limitation on the scope of Recommendation 7.

9.3 If both residence countries have hybrid rules, it is possible for the disallowance to give rise to double taxation – for example, if it is offset against non-dual inclusion income in both jurisdictions (see Final Report, Example 7.1). However, given that dual residence status is in most cases deliberate rather than accidental, it should be possible for taxpayers to be aware of the possibility of double taxation, and by adopting simpler structures, avoid it.

Application to New Zealand

9.4 New Zealand already denies a dual resident company the ability to use a loss to offset the income of other group companies (section IC 7(2)) and to join a tax consolidated group (section FM 31). While this substantially limits the kinds of structures that can give rise to double non-taxation using a dual resident company resident in New Zealand, it does not mean that there are no such opportunities. For instance, New Zealand could not be Country A in the Final Report's Example 7.1, but it could be Country B.

> ***KPMG Comment:*** *It is not clear how New Zealand being Country B could advantage the group in the example. A Co 2 must by definition be dual resident in New Zealand and Country A. This would generally prevent it offsetting the funding loss against BCo's profit. (We assume the operating income amounts should be positive rather than negative in the Example 7.1.)*
>
> *It does not appear that anything is required.*

9.5 The dual resident payer rule raises a number of issues that have been considered in previous chapters. In particular:

- because a deduction is allowed to the extent of dual inclusion income, dual inclusion income needs to be defined – this is considered in Chapter 6;

- determining whether or not a payment is deductible in the other country may require that issue to be determined earlier than when a deduction arises in that country, in which case the ordinary rules applying in that country should govern the question. At the same time the question requires certain entity specific rules in that country to be taken into account;
- the rule can sensibly apply to non-cash deductions such as depreciation and amortisation. Accordingly it is not necessary to restrict it to payments;
- some equity returns that are tax exempt or tax credited on the basis that they are paid out of tax paid income should still be treated as dual inclusion income;
- disallowed amounts should be able to be carried forward and offset against dual inclusion income arising in a later year. Carry-forward will be limited in the same way as it is limited for losses;
- attributed income under CFC rules cannot be treated as dual inclusion income;
- credit for underlying foreign taxes may be limited; and
- if an entity is unable to carry forward its disallowed loss in one country, the other country can allow the loss to be deducted (see Final Report, Example 7.1 paragraph 13).

Submission point 9A

Submissions are sought on the OECD's Recommendation 7 and any issues that may arise in relation to its implementation in New Zealand.

DTA dual resident rule suggestion

9.6 In Chapter 13 of the Final Report it is suggested that countries should consider inserting into their domestic law a rule that deems an entity not to be resident if that entity is resident of another country through the operation of a DTA.[58]

9.7 If incorporated into New Zealand law, this rule would prevent an entity benefitting from a mismatch between New Zealand's domestic law definition of residence and the definition of residence found in any of New Zealand's bilateral DTAs.

9.8 Canada[59] and the UK[60] have domestic law to this effect. New Zealand law currently features a series of provisions that ensure that an entity that is non-resident under a DTA cannot access various features of the New Zealand tax

[58] At para 432.
[59] Section 250(5) of the Income Tax Act 1985 (Canada).
[60] Section 18 of the Corporation Tax Act 2009 (United Kingdom).

system (such as maintaining an imputation credit account).[61] However, New Zealand's rules are not comprehensive, which potentially allows room for abuse. In particular, a company could manipulate its place of effective management under a DTA to avoid New Zealand's corporate migration rules (as they do not provide for a company becoming non-resident under a treaty).

KPMG Comment: *The non-application of the company emigration rules to residency under a DTA was deliberate. There is no analysis to justify a departure from that rule.*

The broader consequences of deeming a non-resident under a DTA to also be non-resident under domestic law is not considered.

For example, a number of New Zealand's DTAs would not protect distributions by such a company of New Zealand sourced income. See article 10, paragraph 8 of the Australia DTA as an example. This would seem to apply to allow New Zealand to tax what would be taxed under the company emigration rule when the distribution is made.

By contrast, deeming such a company to be non-resident would prevent future New Zealand taxation of distributions of New Zealand sourced income. This may be the right outcome as a dual resident is not able to maintain an ICA and a shareholder would be double-taxed as a result.

Submission point 9B

Submissions are sought as to the OECD's DTA dual resident rule suggestion.

[61] See, for instance, sections FN 4, FO 3, HA 6, IC 7, and OB 1 of the Income Tax Act 2007.

CHAPTER 10

Imported mismatches

10.1 Recommendation 8 in the Final Report relates to imported mismatches. It requires a country to deny a payer a deduction for a payment (an *imported mismatch payment*) which meets all of the following requirements:

- is made to a payee in a country that does not have hybrid mismatch rules;
- does not itself give rise to a hybrid mismatch;
- which the payee sets off against a *hybrid deduction*, that is, a deduction for a payment that gives rise to a hybrid mismatch, or a deduction for a payment made to a third person which is offset by that third person against a payment giving rise to a hybrid mismatch.

10.2 The rule only applies if the payer is in the same control group as the parties to the hybrid mismatch, or the arrangement is a structured arrangement to which the payer is a party.

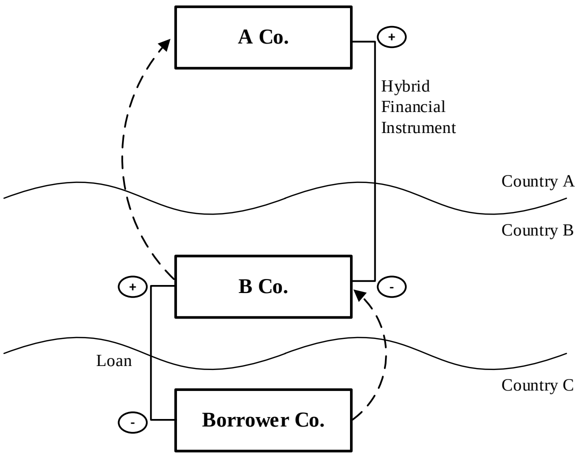
10.3 The rule is not limited to payments in relation to financial instruments. There is no defensive rule requiring inclusion by payees.

10.4 The objective of the rule is to increase the effectiveness of the hybrid rules. Importantly, the rule will not apply to a payment to a person in a country that has implemented hybrid rules.

10.5 The imported mismatch rule is potentially complex to apply. It will require knowledge of the tax consequences of a wide range of transactions within a group. On the other hand, if a group is structured in a straightforward way, and monitors the existence of hybrid mismatches in intra-group transactions, it is likely that the necessary information will be readily available.

10.6 Figure 2.6 (in Chapter 2 of this document) contains a simple example of an imported hybrid mismatch in a structured arrangement, and is reproduced again here.

Figure 10.1: Imported mismatch from hybrid financial instrument (repeated Figure 2.6)



10.7 The arrangement involves A Co providing financing to B Co by way of a hybrid financial instrument, with B Co then lending that money to Borrower Co in Country C. Suppose that Country C is the only one with hybrid rules. Leaving aside the imported mismatch rule, the result of the arrangement is:

- a deduction for Borrower Co;
- no net income to B Co (because its income from the loan equals its deduction on the hybrid instrument); and
- no income to A Co (because Country A treats the financing as equity and does not tax the dividend).

The overall outcome is double non-taxation.

10.8 Accordingly, under the imported hybrid mismatch rule, Borrower Co would be denied a deduction for the lesser of its interest payment and the interest payment by B Co.

Non-structured imported mismatches

10.9 Final Report Examples 8.3 to 8.9 in particular demonstrate the application of the direct and indirect imported mismatch rule. These rules apply to payments within a control group. They apply when a payment is made by a payer in a country with hybrid rules to a payee in a country without hybrid rules, to the extent that payee is:

- a payer under a hybrid mismatch (in which case there is a direct imported mismatch); or
- a payer to a payee who is in turn a payer under a hybrid mismatch (in which case there is an indirect imported mismatch).

Application to New Zealand

10.10 As it is part of the OECD recommendations, it is proposed that New Zealand should introduce an imported hybrid rule. Multinational groups with Australian or UK members will already need to be keeping track of uncorrected hybrid mismatches for the purpose of compliance with the rules in those countries, so the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context.

> ***KPMG Comment**: The document does not refer to other jurisdictions and their requirement, or otherwise, to maintain the relevant documentation. There will be additional compliance for multi-national groups with no Australian or UK presence.*

Refer to our comments on "control group". A control group is wider than a parent-subsidiary relationship. Given this wider definition, access to information is likely to be problematic.

10.11 Accordingly, an imported mismatch rule that is introduced in New Zealand should, so far as possible, be consistent with the rules adopted by the UK and Australia. For instance, the Australian Board of Taxation has noted that a de minimis/safe harbour test may be appropriate for the imported mismatch rule in Australia.

KPMG Comment: *We refer to our earlier comments on the justification for the hybrid rules generally.*

We further note that adopting this recommendation implies that the hybrid recommendations would not be widely adopted. (It appears to apply because intermediate countries have not adopted hybrid rules.) This appears to weaken the justification for New Zealand's implementation – that global adoption will benefit New Zealand.

This recommendation should not be immediately pursued. It will require complicated legislation and compliance will be difficult.

It is therefore better to see if it is required if global implementation does not occur.

Submission point 10

Submissions are sought on whether New Zealand should adopt an imported mismatch rule as recommended by the OECD, and what matters may need to be considered in order to ensure that the rule works as intended, with compliance costs reduced so far as possible.

CHAPTER 11

Design principles, including introduction and transitional rules

11.1 Final Report Recommendation 9 contains recommendations for:

- the design of the hybrid rules, including their interaction with other parts of the legislation, and
- introduction and transitional issues, and how countries should implement the hybrid rules.

Design and interaction

General

11.2 Most of the design principles in Recommendation 9 are uncontroversial, and it is proposed that they would be utilised if the OECD recommendations were adopted in New Zealand. Adhering as closely as possible to the OECD recommendations is more likely to create rules that are:

- Comprehensive. This is important so that the rules do not leave open or create hybrid planning opportunities, while imposing unnecessary compliance costs.
- Consistent with those adopted by other countries. This will go some way to creating a single set of rules, so that the rules do not give rise to unintended gaps or overlaps, and anyone who is familiar with hybrid rules in one country will have a good idea of how they work in another. Nevertheless, some variations between countries are inevitable.

Ordering of hybrid rules

11.3 As recommended in the Final Report (paragraph 286), it is proposed that the OECD recommendations would apply in the following order if implemented in New Zealand:

- hybrid financial instrument rule (Recommendation 1)
- reverse hybrid rule (Recommendation 4) and the disregarded hybrid payment rule (Recommendation 3)
- imported mismatch rule (Recommendation 8)
- deductible hybrid payment rule (Recommendation 6) and the dual resident entity rule (Recommendation 7).

Interaction of hybrid rules and withholding tax

11.4 In accordance with the OECD recommendations, we propose that denial of a deduction for a payment under any of the hybrid rules would not affect its withholding tax treatment.

> ***KPMG Comment:*** *See our comments above. We consider the OECD recommendation is unprincipled as it will lead to double taxation. For New Zealand to proceed with that rule perpetuates an unprincipled approach. This is especially the case for deductions which are deferred pursuant to an arbitrary time limit.*
>
> *We consider that as the hybrid rules are targeted (they apply to particular instruments and entities with particular cashflows), New Zealand's withholding tax rules should be modified if the proposals proceed.*

Interaction of hybrid rules and transfer pricing

11.5 It is proposed that taxpayers are able to apply the hybrid rules in priority to the transfer pricing rules. This will ensure that to the extent a payment is disregarded under the former, there is no need to undertake a transfer pricing analysis.

11.6 When a New Zealand taxpayer is required to include an amount in income under Recommendations 1, 3 or 4, the amount included would be net of (reduced by) any transfer pricing adjustment in the payer country.

Interaction of hybrid rules and thin capitalisation

11.7 Where a deduction is disallowed for an amount of interest under the primary rule in Recommendation 1, or under Recommendations 4 or 8, it is proposed that the thin capitalisation rules be applied on the basis that the disallowed interest and the debt relating to that interest are both disregarded. This will produce the same result as if the interest was a dividend and the debt was equity. It will prevent any double deduction denial of the same payment.

11.8 The interaction with thin capitalisation rules and Recommendations 3, 6 and 7 is more complex due to the carry-forward rule which has no equivalent in New Zealand's thin capitalisation regime. Due to the carry-forward rule, if the disregarded hybrid payments rule applies before thin capitalisation, a permanent deduction denial under thin capitalisation could be replaced by a deduction denial under anti-hybrid rules which may be reversed by the carry-forward rule in a later year (due to excess dual inclusion income).

11.9 To address this problem without giving rise to double denial of interest expense, it is proposed that the carry-forward rule is limited such that the amount of denied deductions able to be carried forward is reduced by the amount of adjustment that would have occurred under thin capitalisation rules if there was no hybrid counteraction. With this limitation, the hybrid rules can apply before thin capitalisation and the intended result of New Zealand's thin

capitalisation rules will be preserved in the event of a carry-forward deduction being allowed in a future year.

11.10 In applying the defensive rule in Recommendation 1 or 3, or Recommendation 2, a New Zealand payee should not consider the thin capitalisation adjustments made by a payer jurisdiction. This is the same approach that is applied to a straightforward interest payment received by a New Zealand payee from a foreign payer. The amount of taxable income is not reduced on account of any interest denial in the payer jurisdiction.

> ***KPMG Comment:*** *This approach appears to be overly complex. The simple principle is a denied deduction is not subject to the thin capitalisation rules. The thin capitalisation rules aim to deny otherwise deductible amounts if the taxpayer breaches allowed debt funding ratios.*
>
> *See our comments above regarding the effect of the denial and carry-forward. It is either a deferral of the incurred rule or a matching rule. In either case, the thin capitalisation rules would apply to confirm or otherwise a deduction allowed at the appropriate time.*

11.11 Table A sets out the interaction between the hybrid rules and the thin capitalisation and transfer pricing rules.

Table A: Interaction of recommendations with other deduction denial rules

	Recommendation	**Transfer pricing**	**Thin capitalisation**
1	**Recommendation 1**		
1.1	Primary rule – deny deduction in payer jurisdiction.	Primary rule first, and then transfer pricing. Saves having to do a transfer pricing analysis in cases where the deduction will be denied in any case.	Primary rule first, then thin capitalisation rules. When applying thin capitalisation, ignore disallowed interest, and treat hybrid debt as equity. Ensures no double disallowance.
1.2	Secondary rule – income inclusion in payee jurisdiction.	Do not apply hybrid rules to the extent a deduction is disallowed by transfer pricing in payer jurisdiction.	Apply secondary rule regardless of any thin capitalisation disallowance in payer jurisdiction – it is issuer-specific. Result is the same as if the payment were interest under a simple debt. Same applies to non-deductibility due to direct use of borrowed funds – see Final Report, paragraph 28.
2	**Recommendation 2**		
2.1	Dividend inclusion in payee jurisdiction.	As for Recommendation 1 secondary rule.	As for Recommendation 1 secondary rule.
3	**Recommendation 3**		

	Recommendation	Transfer pricing	Thin capitalisation
3.1	Primary rule – deduction denial in payer jurisdiction.	Transfer pricing first, then primary rule. Because primary rule allows carry-forward, transfer pricing has to be done anyway.	Primary rule first. However, carry forward reduced to the extent that thin capitalisation would have disallowed a deduction if hybrid rules had not applied. Because primary rule allows carry-forward and thin capitalisation does not, if carry forward is not reduced, deductions will avoid thin capitalisation scrutiny, or have the wrong ratio applied.
3.2	Secondary rule – income inclusion in payee jurisdiction.	Do not apply hybrid rule to the extent a deduction is disallowed by transfer pricing in payer jurisdiction.	As for Recommendation 1 secondary rule.
4	**Recommendation 4**		
4.1	Primary rule – deduction denial in payer jurisdiction.	Primary rule first, and then transfer pricing. As for Recommendation 1.	Primary rule first, then thin capitalisation. As for Recommendation 1.
5.	**Recommendation 5**		
5.1	5.1 – improvements to CFC regimes.	Not a linking rule – transfer pricing treatment in payer jurisdiction not relevant – only tax treatment in establishment jurisdiction. But if an interest payment is subject to a transfer pricing adjustment in the payer jurisdiction and we have a treaty with them, the payee could ask for a correlative adjustment.	Not a linking rule – thin capitalisation treatment in payer jurisdiction not relevant – only tax treatment in establishment and owner jurisdictions.
5.2	5.2 – limiting tax transparency for non-resident investors.	As for Recommendation 5.1, except right to a correlative adjustment clearer.	As for Recommendation 5.1.
6	**Recommendation 6**		
6.1	Primary rule – deny deduction in parent jurisdiction.	As for Recommendation 3 primary rule.	As for Recommendation 3 primary rule.
6.2	Secondary rule – deny deduction in payer jurisdiction.	As for Recommendation 3 primary rule.	As for Recommendation 3 primary rule.
7	**Recommendation 7**		
7.1	Deny deduction in both jurisdictions.	As for Recommendation 3 primary rule.	As for Recommendation 3 primary rule.
8	**Recommendation 8**		
8.1	Deny deduction in payer jurisdiction.	As for Recommendation 1 primary rule.	As for Recommendation 1 primary rule.

Submission point 11A

Submissions are sought on the intended approach to manage the interaction of the OECD's recommendations and New Zealand's withholding tax, transfer pricing and thin capitalisation rules.

Interaction of hybrid rules and the CFC regime

11.12 Recommendation 5.1 as it relates to payments to a reverse hybrid is considered in Chapter 7. Recommendation 5.1 also suggests that countries consider introducing or making changes to their offshore investment regimes in relation to imported mismatches.

11.13 One such change, labelled a "modified hybrid mismatch rule", is set out in paragraphs 29 to 33 of the OECD's Final Report on Action 3: Designing Effective Controlled Foreign Company Rules.[62] The change suggested is that a payment from one CFC to another should be included in CFC income if it is:

- not included in CFC income of the payee; and
- would have been included in CFC income if the parent jurisdiction (the jurisdiction applying its CFC rules) had classified the entities and the arrangement the same way as the payer or payee jurisdiction.

11.14 A more general issue is the extent to which a New Zealand company applying the CFC rules has to determine attributable foreign income when taking into account the application of the hybrid rules.

> ***KPMG Comment:*** *It is not clear that such a rule is required as we would expect that any such income is passive income and already included as CFC income if the active income ratio is breached.*

Submission points 11B

Submissions are sought on:

- the desirability or otherwise of this modified hybrid mismatch rule; and
- the interaction more generally between the CFC rules and the hybrid rules.

Hybrid rules and anti-avoidance

11.15 We propose that the rules would apply before (and therefore would be subject to) the general anti-avoidance provision. This will ensure that the hybrid rules, which generally apply automatically and do not have a purpose requirement,

[62] OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241152-en

cannot be used for a tax avoidance purpose. It is consistent with the way section BG 1 applies to any other tax provision.

> ***KPMG Comment:*** *See our comments above regarding the effect of the introduction of the hybrid rules, and the potential for changes in other countries, to change the analysis for section BG 1 purposes.*
>
> *Further, the hybrid rules will themselves become part of New Zealand's domestic law. Perversely, despite the expectation that alternative arrangements would be used, the use of an alternative arrangement which ensures the anti-hybrid rules do not apply would appear to be at risk of section BG 1 applying to that alternative.*
>
> *We accept that this analysis may be circular and unintended. It should be explicitly dealt with to ensure that a lower tax position for an alternative to a hybrid is not at risk of section BG 1 applying.*

11.16 If New Zealand implements the OECD recommendations, the UK approach[63] of having a specific anti-avoidance provision for its hybrid rules should be adopted. This provision would apply to an arrangement which has a more than merely incidental purpose of reducing taxable income by avoiding the application of either the New Zealand hybrid rules or the equivalent rules in a foreign jurisdiction. Taxable income for this purpose would include income taxable in a foreign jurisdiction as well as New Zealand. This reflects the general purpose and approach of the hybrid rules, which is to counteract the double non-taxation of income without any need to determine which country's revenue has been affected. It may be useful to explicitly state, as the UK does, that in determining whether an arrangement does avoid the application of the rules, reference should be made to the Final Report and any document which replaces or supplements it.

> ***KPMG Comment:*** *See comment above. An intended result is that taxpayers use alternative arrangements. This rule would appear to prevent their use.*
>
> *We note that this is a black letter law approach. The OECD report would suggest that this is not hybrid avoidance. However, we note the uncertain status of the OECD report for New Zealand statutory interpretation as well as our comments regarding the unprincipled approach taken. Both will make the application of the parliamentary contemplation test uncertain. This may encourage Inland Revenue to take and the Courts to accept such arguments.*
>
> *We further note that examples of what Officials consider are unacceptable avoidance of the hybrids rules is required to determine whether this proposal is valid.*

[63] See proposed section 259M of TIOPA 2010 (United Kingdom).

Submission point 11C

Submissions are sought on the proposal to include a hybrid rules-specific anti-avoidance rule.

Legislative design

11.17 The Final Report clearly expects countries to draft domestic legislation implementing the rules, rather than simply incorporating all or some of the Final Report directly into domestic law. Nevertheless, the Report will continue to be an important document in interpreting the legislation, to the extent that interpretation requires an understanding of the purpose of the rules.

11.18 It may be possible or desirable in some areas to legislate broad principles, which could be fleshed out by regulations of some kind. Regulations, or some other form of subsidiary legislation, would have the benefit of being:

- more easily able to be changed than primary legislation;
- more flexible in their form. For example, it would be easier to include detailed examples, and to have extended discussion of the examples, in subsidiary legislation.

11.19 Examples of where some form of subsidiary regulation might be appropriate are:

- fleshing out the imported mismatch rules;
- providing detail on the definition and calculation of dual inclusion income;
- determination of the extent to which CFC taxation can be treated as preventing a D/NI outcome;
- resolution of double taxation outcomes resulting from introduction of the rules in New Zealand or a counterparty country – in this case the Commissioner might be given the power to override the rules where they would otherwise give a double taxation result.

KPMG Comment: *See our submissions on the regulation making powers proposed in the Taxation (Business Tax, Exchange of Information and Remedial Matters) Bill and SOPs. The ability to use regulations and determinations needs to be clearly established so that their validity can be tested.*

We further note that the status of subsidiary legislation in determining Parliament's contemplation for section BG 1 purposes needs to be clearly established. Taxpayers will not wish to be at risk of following a regulation or determination only for Inland Revenue to argue that the application of the subsidiary legislation is contrary to Parliament's contemplation.

Submission point 11D

Submissions are sought on the legislative design proposals set out above.

General rule for introduction

11.20 The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311). Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be. Furthermore, the result achieved by the rules should not generally be a punitive one, rather it involves the loss of an unintended tax benefit. The Final Report also suggests that the rules should generally take effect from the beginning of a taxpayer's accounting period.

> ***KPMG Comment:*** *See our comments above regarding the intended or otherwise granting of a tax benefit and the double taxation effects of denying deductions and applying withholding tax.*
>
> *See also KPMG's previous submissions on proposals to alter the related party NRWT rules. Alternative arrangements are unlikely to be quickly implemented or readily apparent.*

11.21 The Board of Taxation recommended that the Australian rules come into force with respect to payments made on or after the later of 1 January 2018 or six months after enactment. The UK rules come into force for payments made on or after 1 January 2017, which is approximately eight months after the introduction of the Finance Bill which contained the rules.

11.22 The impact of the proposals will in most cases be able to be established now, by reference to the Final Report. We consider that the period from introduction of the relevant legislation to its enactment should give taxpayers sufficient time to determine the likely impact and accordingly the effective date of the legislation should be its enactment date. In accordance with the OECD recommendation, the provisions would then apply to payments made after a taxpayer's first tax balance date following enactment. This is a similar approach to that taken to the implementation of the NRWT anti-deferral rules,[64] except that in this case there would be no early implementation for post-enactment transactions.

> ***KPMG Comment:*** *We disagree. The proposals are detailed, complex and broad in their application. The consultation time frame has not allowed for comprehensive consideration. It is by no means certain that they should apply or in what form they should apply. Our comments*

[64] In the Taxation (Annual Rates for 2016–17, Closely Held Companies and Remedial Matters) Bill.

illustrate this conclusion. Grand-parenting and a reasonable delay (post-enactment) for their implementation should be considered.

11.23 An alternative approach would be the Australian one (application to all payments made or received a fixed period after enactment), which would have the benefit of giving all taxpayers an identical start date for applying the rules.

Submission points 11E

Submissions are sought on whether there are any special circumstances that would warrant departing from the general proposition of no grand-parenting, and whether the proposed effective date is appropriate.

Co-ordination with other countries

11.24 Rules will also be needed to deal with different implementation dates by different countries. Issues are raised in particular if one country applies an accrual basis of income or expense recognition while the other applies a cash basis.

11.25 For example, suppose a hybrid payment in respect of a hybrid financial instrument is made by A Co to B Co, and Country A does not have the hybrid rules but Country B does. B Co will be taxable on the payment. If Country A then introduces the rules, then A Co will be denied a deduction for its payment under the primary rule and B Co will no longer be taxable on that payment. If both companies are on a cash basis and have the same tax accounting period, there is no issue. However, suppose that the two companies have different tax years. Consider B Co's tax year during which the Country A hybrid rules take effect. Country B will need to tax payments received by B Co during the part of its tax year before the start of A Co's tax year, and not tax those received afterwards.

11.26 Example 2.3 in the Final Report concerns a transitional situation where a payer of a deductible/exempt dividend is subject to the primary rule in year two, but in year three the payee country introduces a domestic dividend exemption denial rule, in accordance with Recommendation 2.1. The payer is claiming a deduction on an accrual basis, but the payee is recognising income on a payments basis. The effect of the introduction of the exemption denial rule in the payee country is that the payer is entitled to a full deduction in year 3, and the payee is taxable on the portion of the payment for which a deduction has been claimed. That is less than the entire payment, since a portion of the payment was accrued by the payer in year 2, and was non-deductible due to the primary rule.[65]

[65] Note that there is an error in the example. B Co's year 4 interest deduction for tax purposes should be 75 and its year 4 taxable income should be 25.

KPMG Comment: *We note that this appears to be the only section where the document has any concern for double taxation. The same concern should be applied to the rest of the proposals.*

Submission point 11F

Submissions are sought on any particular situations that might require particular care to avoid double taxation, beyond those set out here and in the Final Report. It may be desirable to provide some flexibility for the Commissioner to make discretionary adjustments where co-ordination issues mean that the application of the rules in two countries gives rise to double taxation.

CHAPTER 12

Key definitions

12.1 The last three recommendations in the Final Report are about definitions. Most of the definitions are straightforward and they should be adopted so far as necessary. In this Chapter the question of how some significant definitions might be incorporated into New Zealand law is considered.

Financial instrument

12.2 Recommendation 1 applies primarily to "financial instruments". Recommendation 1.2(c) is that countries treat as a financial instrument any arrangement where one person provides money to another in consideration for a financing or equity return.

12.3 In New Zealand a financial instrument would include a financial arrangement as defined in subpart EW. However, a number of the exclusions from the financial arrangement definition would not apply.

- Given the purpose of the hybrid rules, a financial instrument would include shares in a company, as defined for tax purposes. It would not include an interest in a vehicle treated as fiscally transparent for New Zealand purposes, such as a partnership or look-through company.
- Variable principal debt instruments would be included.
- The definition should also include annuities, farm out arrangements, share lending arrangements and livestock or bloodstock hire purchases, since all of these seem to have some financing component, and could be entered into in a commercial context.

12.4 It is proposed that the remaining excepted financial arrangements would not be financial instruments. This means that operating leases would be outside the definition, while finance leases and hire purchase agreements would be within it.

Structured arrangement

12.5 The definition of a "structured arrangement" is set out in Recommendation 10 of the Final Report, and discussed in some detail. The core definition is that it is an arrangement where either:

- the hybrid mismatch is priced into the terms of the arrangement; or
- the facts and circumstances indicate that it has been designed to produce a hybrid mismatch.

12.6 Facts and circumstances which would be taken into account in determining whether or not an arrangement has been designed to produce a hybrid mismatch would include whether or not the arrangement:

- incorporates a term, step or transaction used to create a hybrid mismatch;
- is marketed as a tax advantage product where some or all of the tax advantage derives from a hybrid mismatch;
- is marketed primarily to investors in a country where the hybrid mismatch arises;
- contains features that alter the terms if a hybrid mismatch does not exist, for example, a tax gross-up provision; or
- produces a negative return absent the hybrid mismatch.

12.7 To incorporate this definition into New Zealand law, it is proposed to use the existing "arrangement" definition, and to define a structured arrangement as one where either:

- the hybrid mismatch is priced into the terms of the arrangement; or
- the arrangement has a purpose or effect of producing a hybrid mismatch.

12.8 As with the existing *Ben Nevis* factors which apply in the context of section BG 1, we propose that the list of factors provided in the Final Report be reproduced in guidance, rather than being legislated. This is also the approach recommended by the Australian Board of Taxation.

> ***KPMG comment:*** *A definition drafted per the second bullet point in 12.7 does not duplicate the facts and circumstances tests in 12.6. As Officials are aware, guidance is not binding on the Commissioner. It is therefore possible for an arrangement which is analysed as producing a hybrid mis-match to be characterised as a structured arrangement.*
>
> *The example we have used is of an investment in an Australian unit trust which is a FIF and to which the FDR method is applied. Using the analysis in paragraphs 5.48 to 5.51:*
>
> — *Distributions from the unit trust (which are dividends) are not taxable in New Zealand;*
> — *Distributions from the unit trust are deductible to the unit trust (a dividend from a company in New Zealand terms). The unit trust does not pay tax on such distributions. It withholds tax payable by the investor.*
>
> *This is a hybrid mis-match: a D/NI result. It has that purpose or effect. Although there would not normally be any of the facts and circumstances described in 12.6, it would appear to be a structured arrangement.*

Related persons

12.9 Recommendation 11.1(a) is that two persons are related if they are in the same "control group" (considered below) or:

- one of the persons has a 25 percent or greater interest in the second; or
- a third person holds a 25 percent or greater interest in both.

12.10 For this purpose, a person who acts together with another person in respect of the ownership or control of any investment in another person will be treated as also owning that other person's investment.

12.11 Two persons will be treated as acting together in respect of ownership or control of an investment if:

- they are family members. A person's family members are:
  - persons who are within two degrees of relationship of the person, and those persons' spouses;
  - the person's spouse;
  - persons who are within two degrees of relationship of the first person's spouse;
- one regularly acts in accordance with the wishes of the other;
- they have entered into an arrangement that has a material effect on the value or control of the investment; and
- the ownership or control of the investment is managed by the same person or group of persons.

12.12 An investment in an entity can be a voting interest or an equity interest or both. A voting interest can apply to non-corporate as well as corporate entities, and is a right to participate in decision making concerning distributions, changes in the person's constitution or the appointment of a director, broadly defined so that includes the persons who have management and control of an entity.

12.13 A look-through test applies to trace interests through interposed entities.

12.14 This approach is similar to that taken to determining whether or not two companies, two natural persons, and a company and a person other than a company, are associated under subpart YB 2 to YB 4 and YB 13 and YB 14, subject to the fact that for two companies, the test generally requires a 50 percent common ownership.[66] However, the application to trusts and partnerships seems somewhat different. While it would make sense to build so far as possible on existing definitions, it is likely to be preferable to do so by using a stand-alone definition which combines existing concepts plus the modifications necessary to ensure that New Zealand's hybrid regime has the same scope as others enacted in accordance with Action 2.

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[66] Also, the definition of a family member seems somewhat broader than the definition of a relative in section YA 1. For example, a person's sister's spouse is a family member but not a relative. We propose that the broader definition be used in this context.

KPMG Comment: *It is not clear that the compliance difficulties that will arise from an extended definition of related persons and control groups have been adequately considered.*

Control group

12.15 Two persons will be in a control group if:

- they are consolidated for accounting purposes, either under IFRS or applicable GAAP;
- one of them effectively controls the other, or a single person effectively controls both;
- one of them has a 50 percent or greater investment in the other, or a single person has a 50 percent or greater ownership of both; or
- they are associated enterprises under Article 9 of the OECD Model Treaty, which defines when transfer pricing adjustments may be made. The Final Report states that countries should apply their own transfer pricing thresholds for this purpose, so that if transactions between two entities are subject to transfer pricing adjustments under domestic law, they are in a control group for purposes of the hybrid rules (Final Report, paragraph 367).

12.16 In determining control and ownership, the same rules apply as those in determining ownership interests for purposes of the related person definition. In particular, interests of persons who act together in respect of their interests, or are treated as doing so, will be aggregated as set out in paragraph **Error! Reference source not found.** However, control is clearly a broader concept than ownership. For example, a substantial shareholder in a widely held company may have effective control over the appointment of directors, despite not having 50 percent of the rights to appoint the directors (Final Report, paragraph 364).

12.17 In the New Zealand context, in addition to the issues considered above in relation to the related person definition:

- consideration will need to be given to whether the existing reference to "control by any other means" in section YB 2(3) would be interpreted by New Zealand's courts in a manner consistent with its interpretation in the Final Report. If not, a separate definition may be required;
- in accordance with the Final Report, two entities will be in a control group if they are associated persons for purposes of the transfer pricing provisions in subpart GC.

Payment

12.18 "Payment" includes non-monetary flows, such as a transfer of shares or any other asset. It includes not only things convertible into money, but also anything that would be paid for if provided at arm's length. In New Zealand terms it would be covered by the definition of "money" which applies for purposes of the financial arrangement rules.

Submission point 12

Submissions are sought on any aspects of the OECD's recommended definitions and how they could be adopted by New Zealand.

4 November 2016

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SUBMISSION: ADDRESSING HYBRID MISMATCH ARRANGEMENTS

Introduction

1. This letter contains Westpac's submissions on the Government discussion document *Addressing hybrid mismatch arrangements* released on 6 September 2016 ("**Discussion Document**").[1]

2. In summary, our submissions are:

   (a) regulatory capital instruments should be excluded from the scope of New Zealand's hybrid mismatch rules at least until it is clear to what extent other countries (and Australia in particular) will follow the United Kingdom's approach of excluding regulatory capital from the scope of such rules; and

   (b) if regulatory capital instruments are not excluded from the rules, grandparenting in full should be available so that the rules do not apply to regulatory capital instruments issued prior to the release of the Discussion Document, or (in the alternative) at least to instruments issued prior to the release of the OECD Report.

First submission: regulatory capital instruments should be excluded from the hybrid mismatch rules

Discussion Document proposals

3. The Discussion Document states (at paragraph 5.60) that it is not proposed to exclude regulatory capital instruments from the implementation of hybrid mismatch rules in New Zealand. The Discussion Document calls for submissions as follows:

> **Submission point 5H**
>
> Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital.

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[1] The Discussion Document proposes that New Zealand adopt the recommendations contained in the OECD report *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* ("**OECD Report**") released on 5 October 2015.

Regulatory capital instruments should be excluded from the hybrid mismatch rules

4. We submit that regulatory capital instruments should be excluded from the implementation of hybrid mismatch rules in New Zealand for these reasons:

(a) The Discussion Document indicates (page 1) that "the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches". Regulatory capital instruments, on the other hand, meet regulatory requirements (administered, in the Australasian context, by the Reserve Bank of New Zealand ("**RBNZ**") and the Australian Prudential Regulation Authority ("**APRA**")) for banks to maintain capital. The terms of such instruments are prescribed by the RBNZ and APRA. Regulatory capital instruments are therefore not tax driven transactions, do not amount to what the Discussion Document describes as "deliberate exploitation of hybrid mismatches", and are therefore outside the core concern identified in the Discussion Document.

(b) The OECD Report (at page 11) on which the Discussion Document is based leaves open the question of whether hybrid mismatch rules that countries may enact to implement the OECD Report recommendations should apply to regulatory capital instruments or should instead exclude such instruments from their scope. An OECD public discussion draft *BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* released in March 2014 ("**OECD Draft**") preceded the OECD Report. The OECD Draft indicated (at paragraph 158) that the separate consideration of regulatory capital was due to the "widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated". New Zealand would therefore be acting consistently with OECD recommendations were it to exclude regulatory capital instruments from its hybrid mismatch rules.

(c) The Discussion Document indicates (at page 1) that "[i]t is expected that most hybrid arrangements would be replaced by more straightforward (non-BEPS) cross-border financing instruments and arrangements following the implementation of the OECD recommendations in New Zealand". Given RBNZ and APRA requirements, regulatory capital instruments may not be simply replaced with more straightforward financial instruments.

(d) As the Discussion Document acknowledges (at paragraph 5.38) the OECD Report gives countries the option to exclude regulatory capital from their hybrid mismatch rules.[2] The rules implementing the OECD recommendations in the UK exclude regulatory capital. New Zealand should follow the UK's lead on this issue (especially while it is not certain what approach Australia will take).

Alternatively, regulatory capital instruments should be excluded from the hybrid mismatch rules pending clarification as to how other countries will proceed

5. Alternatively, if a permanent exclusion is not accepted, regulatory capital instruments should at least be excluded from the implementation of hybrid mismatch rules in New Zealand pending greater clarity as to how other countries (in particular Australia) will treat regulatory capital instruments under their hybrid mismatch rules. The effects of the

[2] The OECD Report states (at page 11) "[a]s indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital". The reference to "intra-group hybrid regulatory capital" appears to reflect the assumption in the OECD Draft (at paragraph 160) that regulatory capital issued to third party investors would be "unlikely to be caught" by hybrid mismatch rules.

hybrid mismatch proposals on the New Zealand economy cannot be known or predicted without first knowing what rules other countries will implement. For the banking industry, the position Australia will take is significant and is currently unknown.

6. For example, the OECD Report recommends that where a mismatch arises under a frankable-deductible instrument (see Example 2.1 of the OECD Report) the primary response is for the jurisdiction providing the dividend relief (in this case Australia) to disallow that relief. It seems highly likely that Australia will implement the OECD Report proposals to some extent.[3] Accordingly, the circumstances in which a deduction may need to be denied under New Zealand's hybrid mismatch rules to counteract a hybrid mismatch under a frankable-deductible instrument would be if Australia:

   (a) makes a policy choice to exclude certain frankable-deductible instruments from its hybrid mismatch rules; or

   (b) has different implementation provisions from those applicable in the case of New Zealand's hybrid mismatch rules (eg, a different commencement date or approach to grandparenting).

7. In either circumstance, it would seem appropriate (when the OECD Report recommends that Australia provide the primary response to the arrangement) for New Zealand to consider Australia's position when formulating its own position. To avoid the risk of New Zealand adopting rules without regard to Australia's policy choices, regulatory capital instruments should be excluded from the hybrid mismatch rules at least until it is clear what approach Australia will take in respect of regulatory capital instruments.

Second submission: grandparenting should be available - proposals should not apply to existing regulatory capital instruments

Discussion Document proposals

8. The Discussion Document indicates that no grandparenting should apply if the hybrid mismatch rules are implemented in New Zealand. The Discussion Document also states (at paragraph 11.20):

> The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311). Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be. ...

9. The Discussion Document calls for submissions as follows:

> **Submission points 11E**
>
> Submissions are sought on whether there are any special circumstances that would warrant departing from the general proposition of no grandparenting, and whether the proposed effective date is appropriate.

Regulatory capital instruments should be subject to grandparenting

10. If regulatory capital instruments are not excluded from the implementation of the hybrid mismatch rules, we submit that full grandparenting should be available for regulatory capital instruments issued prior to the release of the Discussion Document, or at least for instruments issued prior to the release of the OECD Report.

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[3] The Discussion Document (at paragraph 3.12) states that the Australian Government has committed to implementing OECD's recommendations.

11. Full grandparenting should be available for regulatory capital instruments for these reasons:

(a) The main justification offered in the Discussion Document for no grandparenting (that the "rules generally apply to arrangements between related parties or within a control group [such that] restructuring arrangements should not be as difficult as it might otherwise be") is not applicable to many regulatory capital instruments because they are held by third party investors. Any redemption (even if permitted under an instrument's terms and approval is given by the relevant regulators, which cannot be guaranteed) would affect third parties, which typically include a large proportion of retail investors. In addition, the appetite for regulators to reduce the amount of regulatory capital on issue is low given global regulators are directing banks to increase capital levels.

(b) If regulatory capital instruments are not subject to grandparenting, existing instruments would likely need to be refinanced in the Australian or New Zealand domestic markets. Given that multiple banks would likely need to access these markets at the same time (if regulatory capital instruments are not subject to grandparenting), it would be difficult to refinance all of the affected instruments. This refinancing would be in addition to banks' existing Additional Tier 1 capital needs of approximately A$4-$6 billion per annum in aggregate. Given the limited capacity of the Australian and New Zealand domestic markets to absorb regulatory capital instruments in any year, multiple banks seeking to refinance regulatory capital instruments may cause market volatility and significantly increase the execution risk for such transactions, thereby undermining confidence in the markets. It is also possible that the Australian and New Zealand domestic markets would simply not be able to absorb all of the required regulatory capital issuances.

(c) The vast majority (if not all) regulatory capital instruments currently on issue were issued before the Discussion Document was released and, in most cases, prior to the release of the OECD Report. Further, prior to the OECD Report there was an expectation that any changes affecting hybrid arrangements would not apply to bank regulatory capital transactions, a position the OECD Report allows for and which the UK (one of the first jurisdictions to implement the OECD Report proposals) adopted.

12. For these reasons, if our first submission (that regulatory capital instruments should be excluded from the hybrid mismatch rules) is not accepted, our second submission should be accepted. That is, the hybrid mismatch rules should not apply to any regulatory capital instruments issued before the release of the Discussion Document, or (in the alternative) to instruments issued before the release of the OECD Report.

Peter King

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10 November 2016

Addressing hybrid mismatch arrangements
C/- David Carrigan, Acting Deputy Commissioner
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WELLINGTON 6140

Dear David

ADDRESSING HYBRID MISMATCH ARRANGEMENTS

We are writing to submit on the discussion document *"Addressing hybrid mismatch arrangements"* (the "Discussion Document"). We are members of the Corporate Taxpayers Group (CTG), who is also making a submission on this topic; however, given the importance of this matter we are making a separate submission in respect of submission point 8 – foreign branches.

We have previously advocated for and continue to be supportive of an active income exemption for foreign branches. Extending the active income exemption for branches was on the Government's Tax Policy Work Programme from 2010-2015 and was first referred to in the December 2006 International Tax Review discussion document. Although we understand why this reform was deferred, we consider the deferral to be disappointing and are pleased it is again being considered.

Regardless of whether the proposals to adopt the deductible hybrid payment responses proceed, a foreign active branch exemption should be enacted. As we have noted previously (in submissions to Inland Revenue policy officials and the Minister of Revenue) we believe the treatment of branches should, where possible, mirror the treatment of CFCs. In our view, businesses that operate as subsidiaries or branches are no different from an operational view point and should be treated as such.

We understand the connection between the active income exemption for branches and BEPS, and that the introduction of such an exemption would restrict the flow through of foreign losses against the New Zealand tax base. We believe it is more appropriate that reforms should be shaped as an extension of the active income exemption for CFCs (which already contains robust base protection measures). This would result in a comprehensive international tax framework that is equally applicable to branches and subsidiaries and ensure tax consequences do not distort business structure decisions. We also consider this critical to reducing the current compliance costs that arise when operating offshore through a foreign branch.

The extension of the active income exemption to branches would materially assist in eliminating the potential for inappropriate outcomes without detailed hybrid rules applying to foreign branch structures. This should reduce compliance costs that will likely arise as a result of the implementation of the proposals.

We understand that there are currently concerns around the timing of when the hybrid mismatch proposals should be adopted and the consensus appears to be that New Zealand should align timing with other relevant jurisdictions. We understand that adoption in Australia is currently being delayed

until the treatment of regulatory capital is considered further and this may delay implementation in New Zealand. Implementation of the active foreign branch exemption in New Zealand in the meantime could demonstrate that policy officials are actively taking steps to address BEPS concerns. Australia has had an active foreign branch exemption for some time and therefore there is no reason to delay reform to New Zealand's foreign branch rules.

We set out below the background on our business and we reiterate and expand on the comments above.

Background

Fisher & Paykel Healthcare Corporation Limited (and its branches and subsidiaries) is a leading designer, manufacturer and marketer of products and systems for use in respiratory care, acute care and the treatment of obstructive sleep apnea.

Our headquarters, research and development facilities and New Zealand manufacturing operations are located in East Tamaki, Auckland, with products sold in over 120 countries worldwide. We currently have close to 30 offshore entities (subsidiaries and branches), nearly all of which sell and distribute our products. Principal sales and distribution sites are located in the United States, the United Kingdom, Europe, Asia and Australia.

Our competitors are predominantly headquartered in the United States or Europe with operations in multiple jurisdictions. We are therefore typically competing against companies which have enjoyed the benefits of an active income exemption for subsidiaries and branches or something similar for some time.

Comments

Extending the active income exemption to foreign branches **with minimal further delay** would, in our view:

- help ensure that the momentum generated from the CFC/FIF reforms is not lost;
- materially reduce the compliance costs that New Zealand based multi-nationals incur in relation to foreign branch activities;
- improve New Zealand's international competitiveness with our major trading partners and competitors, including Australia;
- with respect to our business, represent New Zealand taking another step forward in levelling the playing field between ourselves and our foreign headquartered competitors.
- would demonstrate that policy officials are actively taking steps to address BEPS concerns.

As noted previously, we believe the treatment of branches should, where possible, mirror the treatment of CFCs. The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project *Designing Effective Controlled Foreign Company Rules* ACTION 3: 2015 Final Report contemplates the application of CFC rules focussing on the attribution of income that gives rise to BEPS concerns (i.e. passive income) to foreign branches. The application of an active income exemption to branches is consistent with the recommendations in the report. We support the view that the relevant focus area is on the type of income rather than the type of entity and believe the most coherent legislative solution is to extend the current CFC treatment.

The introduction of the proposals contained in the Discussion Document would restrict the flow through of foreign losses against the New Zealand tax base and there are concerns about the impact on taxpayers of removing this flow through of losses from foreign branches (especially for small start-up type businesses). While this is generally only a timing benefit as future income arising from the foreign branch should also be recognised in New Zealand, it is possible for taxpayers to structure their arrangements such that this is not necessarily the case. Therefore, in some situations tax consequences are currently distorting business structure choices.

The potential issues with use of foreign branch losses against New Zealand income are detailed in the Discussion Document. The general principle is that foreign branch losses should only be able to be used against foreign branch income which is also taxable in New Zealand (referred to as "dual inclusion income") unless there is no ability to otherwise utilise the losses in the foreign jurisdiction. The

extension of the active income exemption to branches would materially assist in eliminating the potential for inappropriate outcomes without the need for the application of detailed hybrid rules.

If the proposals in the Discussion Document do not proceed we consider the active branch exemption should still be enacted. If there is concern about denying the flow through of losses from foreign branches (especially for small start-up type businesses), we suggest introducing an elective regime under which taxpayers could choose to make an irrevocable election into an active exemption regime for foreign branches. This would provide the necessary compliance relief and alignment with CFC/FIF treatment for taxpayers that make the election, but would retain the status quo for those that do not make the election. We see merit in an elective regime with appropriate base maintenance protection measures to prevent the potential opportunities that exist for inappropriate outcomes even within the current regime.

Finally, we note that we are a New Zealand business employing a large and growing number of New Zealanders. We want to continue to be based in New Zealand and pay the majority of our tax here. We encourage officials to ensure we and other New Zealand headquartered businesses have access to international tax legislation we deserve to assist (or at the least not inhibit) this intention and our competitive position.

We appreciate the opportunity to provide a submission on the paper and we would be happy to be contacted to discuss any points raised in this submission. In the first instance, please contact Rachael Bull.

Yours faithfully

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#008

Response to

Inland Revenue

on the

Addressing Hybrid mismatch arrangements

11 November 2016

Strictly Confidential

1.0 INTRODUCTION

1.1 This submission has been prepared by Bank of New Zealand ('BNZ') in response to Inland Revenue's ('IR') discussion document, 'Addressing hybrid mismatch arrangements' released in September 2016 (the 'Discussion Document').

1.2 BNZ welcomes this opportunity to provide a response to the Discussion Document and while we are grateful for the additional time allowed for submissions, we note that the relatively short timeframe in which the proposals are intended to be advanced is challenging. The proposals are complex and significant time is required to properly understand the potential impacts the proposals may have. Given the complexity and the risk of unintended consequences in implementation, an extended timeframe for advancing these proposals should be considered.

1.3 BNZ is a member of the Corporate Taxpayers Group ('CTG') and has been involved in the submission the CTG has made on the Discussion Document. While BNZ is in total alignment with the submissions made by the CTG, BNZ wishes to make an additional specific submission on certain aspects of the proposals. We outline those submission points below.

2.0 EXECUTIVE SUMMARY

2.1 BNZ submits that there are good reasons to adopt many of the OECD recommendations provided those recommendations are in the best interests of New Zealand and are appropriate in the New Zealand context. BNZ questions the need for wholesale adoption of the OECD recommendations, particularly as several of the concerns the OECD recommendations aim to counter do appear to be adequately addressed through existing New Zealand tax rules. BNZ would prefer to see targeted measures directed at real as opposed to theoretical risks to the New Zealand tax base.

2.2 Any of the OECD recommendations that are implemented in New Zealand need to be in harmony with other proposed and pending New Zealand tax law changes, and the OECD recommendations should not be considered and evaluated in isolation. BNZ hopes to see, as part of the consultation process, further consideration of how the OECD recommendations align with, for example, recently enacted changes to non-resident withholding tax, Approved Issuer Levy and branch structure rules.

2.3 Importantly, BNZ submits that banking regulatory capital should be excluded from the hybrid financial instrument rule. Hybrid instruments are commonly used by New Zealand registered banks for regulatory capital purposes and the hybrid nature of these instruments is a consequence of the strict capital adequacy rules imposed by the Reserve Bank of New Zealand. In the regulatory capital context, hybrid instruments are not entered into with a tax planning purpose and absent the regulatory capital requirements, BNZ would prefer to use ordinary debt funding without hybrid features.

2.4 If the Government decides not to exclude regulatory capital, then BNZ submits that the scope of application and timing of introduction of the proposals to regulatory capital should be in line with any introduction of the equivalent rules in Australia.

2.5 If the Government decides not to exclude regulatory capital, BNZ submits that grandfathering of regulatory capital should be available for regulatory capital where the hybrid instruments were issued before the date legislation to enact the OECD recommendations is introduced. The grandfathering period should last for the term of the financial instrument.

2.6 BNZ submits that where a deduction/non-inclusion outcome is only temporary, the approach recommended by the Australian Board of Taxation should also be applied in New Zealand.

2.7 BNZ submits that any denied deductions in New Zealand should be able to be carried forward and used in future periods if the income is effectively taxed in the other jurisdiction. This is particularly

important in the trans-Tasman context where both Australia and New Zealand operate imputation regimes. Absent the ability to carry forward deductions the proposals will result in double taxation when company tax and shareholder tax are considered in totality.

3.0 SUBMISSIONS

High-level comments

3.1 BNZ is supportive of the overall intent of the proposals to neutralise the effect of hybrid mismatch arrangements as a means of countering abusive cross border tax structures. However, any changes in New Zealand tax legislation must be appropriate to the New Zealand tax context and must be evaluated in conjunction with other pending legislative changes and the particular features of New Zealand's tax system. Changes as fundamental as those proposed in the Discussion Document should not be considered in isolation.

3.2 BNZ does not support wholesale adoption of the OECD recommendations. The recommendations should only be adopted to the extent they address a real (as opposed to theoretical) risk or are demonstrably in the best interests of New Zealand.

3.3 BNZ notes that, while stating our general support for the direction and intent of the proposals, BNZ considers that the Discussion Document likely overstates the potential benefit to New Zealand as it is likely that hybrid financial instruments would be replaced with deductible debt. In most cases the level of debt and the amount of interest deduction would not be materially affected if hybrid instruments issued by New Zealand multinationals were replaced with vanilla debt. The Optional Convertible Note (OCN) cases cited at 3.17 are a case in point where if, instead of an OCN, simple debt funding was provided to the New Zealand subsidiary, the level of deductible interest expense would be broadly the same as the deductions claimed the OCN. Any revenue gain to New Zealand would be minimal despite a significant increase in compliance costs along with a likely increase in the cost of capital in New Zealand if regulatory capital is not excluded.

3.4 While BNZ understands Government's desire to align as much as possible with other OECD members, it still needs to balance the overall costs the proposals will impose on New Zealand taxpayers with the expected net benefit to New Zealand. The proposals should not be adopted wholesale without a more detailed consideration of whether it is in fact in the best interests of New Zealand to do so. In respect of the proposal not to exempt regulatory capital, BNZ considers that the additional cost of capital in New Zealand does not appear to be justified by the tax risks the proposals seek to address.

Timing mismatches - Submission points 5C

3.5 BNZ supports an approach such as that recommended by the Australia Board of Taxation to exclude temporary mismatches from the proposed rules.

Regulatory capital – submission point 5H

3.6 BNZ submits that banking regulatory capital should be excluded from the application of the hybrid mismatch rules.

3.7 The OECD report explicitly gives countries a choice as to whether to exclude regulatory capital, and the United Kingdom, the first country to adopt the OECD recommendations, has chosen to exclude regulatory capital. It is not yet clear how other countries will treat regulatory capital and it is not in New Zealand's interests to be the only country to apply the OECD recommendations to regulatory capital. At the very least, New Zealand should defer a decision on the application of regulatory capital until it is more clear how other jurisdictions intend to progress.

3.8 The use of hybrid instruments for regulatory capital purposes can and should be distinguished from the hybrid financial instruments that are the target of the hybrid financial instrument rule. Importantly, New Zealand banks do not use hybrid financial instruments with a purpose or intent of achieving a tax mismatch, rather, the use of such instruments is a direct consequence of the regulatory capital rules requiring that funding instruments for New Zealand banks have equity like features and loss absorbing qualities.

3.9 The OECD report states at paragraph 278 that its recommendations are not intended to identify lost tax revenues but are to discourage the use of hybrid instruments and hybrid entities. This purpose is appropriate, however it is clearly at odds with the New Zealand regulatory capital rules that effectively require hybrid instruments to be used.

3.10 The IR Discussion Document does not provide any reasoning for IR's preference to not exclude regulatory capital. In contrast, BNZ considers that there are good reasons for regulatory capital to be excluded.

3.11 Hybrid financial instruments that are used for regulatory capital purposes are used in order to provide funding to New Zealand banks that meet stringent regulatory capital requirements and at the same time provide a competitive cost of funds to New Zealand banks. In absence of the regulatory capital restrictions, BNZ's preference would be to obtain funding through vanilla debt as it is simpler and cheaper to implement than a hybrid instrument.

3.12 If regulatory capital becomes subject to the proposals, the denial of a deduction in New Zealand becomes an increase in the net cost of funds to the New Zealand bank. This will inevitably (directly or indirectly) lead to an increased cost of capital to New Zealand businesses and is counter to the Government's Business Growth Agenda.

3.13 New Zealand's existing tax rules include specific banking thin capitalisation provisions which define the level of debt and therefore the relative interest deductions Parliament has contemplated and deemed appropriate. BNZ, operates well within these prescribed limits and will continue to do so. Absent the regulatory capital rules New Zealand banks operate under, the funding would not take the form of a hybrid instrument and would be ordinary debt where the interest deductions would not be subject to the proposed hybrid financial instrument rule. There is no suggestion in the discussion document that New Zealand's banking thin capitalisation rules are not operating effectively.

Transitional rules

3.14 If Government decides not to exclude regulatory capital from the scope of the proposals, BNZ submits that hybrid financial instruments that qualify as regulatory capital should be grandfathered. The grandfathering should apply to all qualifying hybrid instruments that have been issued prior to the date the new legislation is introduced into parliament and should continue to be grandfathered until the instruments mature, are converted or are repaid.

3.15 The Discussion Document assumes that winding up regulatory capital can be done quickly and easily. This is not the case. Reserve Bank approval is likely to be required and suitable alternative regulatory capital must be found. In addition, in some circumstances external investors may be impacted and securities and financial markets legislation may need to be complied with. For these reasons, BNZ submits that qualifying regulatory capital should be eligible for grandfathering for the life of the instrument.

3.16 Also, BNZ does not consider that New Zealand banks have had sufficient time to consider the impact of the proposals on the basis that the OECD recommendations were published in the OECDs final report in October 2015. The OECD report explicitly gives a choice to each country as to whether to include regulatory capital in the scope of the proposals. As mentioned earlier in this

submission, some jurisdictions have chosen to carve out regulatory capital, while others, most notably Australia, are considering their position. Therefore, until the release of the IR Discussion Document in September 2016 it was not clear what New Zealand's position on this would be.

3.17 Regulatory capital issuances are months in the planning and the structure, terms and pricing of the instruments cannot be easily and quickly altered. Further, until legislation is introduced, New Zealand banks cannot be certain of the extent their various funding structures are impacted and for that reason, grandfathering should be available for all regulatory capital hybrid instruments that have been issued before the date new legislation is introduced into parliament.

Hybrid transfers - Submission point 5I

3.18 BNZ submits that New Zealand should include an exemption for hybrid transfers where a trader of a financial instrument is a party. Repo and security lending arrangements are commonly used by banks and their corporate customers to facilitate short term funding. Such transactions are not entered into with a purpose of achieving a tax mismatch and given the typically short term nature of these transactions the risk to New Zealand is likely to be insignificant and would not justify the complexity involved in bringing these transactions within the scope of the proposals.

Interaction with withholding taxes - Submission point 11A

3.19 BNZ submits that the New Zealand withholding taxes outcomes should be amended to ensure they reflect the in-substance tax outcome effected by the OECD recommendations. For example, application of the primary rule in the New Zealand setting is equivalent to a re-characterisation of a debt instrument as equity (i.e. treating a deductible coupon payment as a non-deductible dividend payment). BNZ submits that the withholding tax impost should reflect this re-characterisation and withholding tax should be levied as if the payment were a dividend payment.

3.20 Alternatively, if withholding tax continues to apply to interest payments on hybrid financial instruments, a deduction should be allowed in New Zealand to the extent that withholding tax has been paid. The rationale for the anti-hybrid rules is explicitly to prevent double non-taxation. Where New Zealand withholding tax has been imposed there is clearly a level of tax imposed on the recipient of the payment, albeit in New Zealand rather than the foreign jurisdiction. It seems a logical conclusion that if tax has been suffered by the recipient of a payment of income, there is no need to deny a deduction to the payer as there is no double non-taxation to counteract.

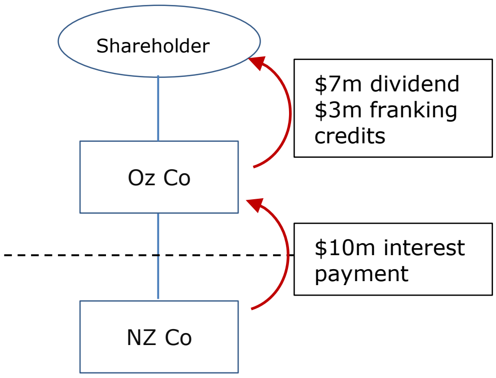
The Trans-Tasman context

3.21 It is well understood that a significant proportion of foreign direct investment into New Zealand is from Australia. The tax settings present in this wider context should not be ignored when considering whether there is a compelling case for wholesale adoption of the OECD recommendations.

3.22 Specifically, New Zealand and Australia are unique internationally in that both countries continue to have imputation regimes. The nature of an imputation regime is that corporate tax effectively becomes an interim tax on the shareholders, meaning that even if a deductible/non-inclusion outcome appears to arise at the corporate level, the operation of the imputation regime means that the income is taxed on distribution to shareholders. The OECD gives little consideration to this in its final report.

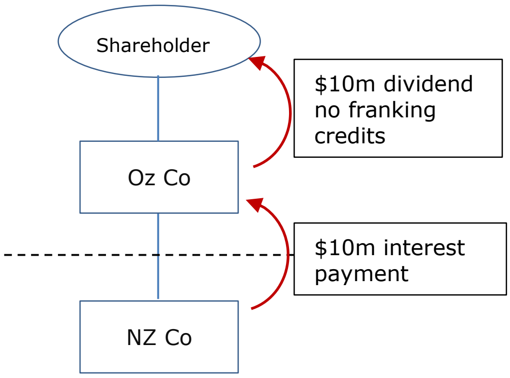
3.23 As an example, consider a New Zealand subsidiary of an Australian company with Australian resident shareholders. The Australian parent provides funding to its New Zealand subsidiary. Assume the New Zealand entity incurs an interest cost of $10m, which in scenario 1 below is incurred on an intercompany loan and in scenario 2 is interest incurred on a hybrid instrument where the coupon payments under the hybrid are not taxed in Australia.

3.24 *Scenario 1 – intercompany loan*



3.25 NZ Co claims a deduction in New Zealand for the interest cost while Oz Co has $10m of taxable income and so pays $3m of Australian income tax. When the profit derived by Oz Co is paid to its shareholder by way of dividends, franking credits are attached. Assuming the shareholder is subject to a 37% marginal tax rate in Australia, the shareholder has a tax liability of $3.7m which is partially satisfied by franking credits of $3m. A further $0.7m of tax is paid by the shareholders resulting in total tax paid in Australia of $3.7m.

3.26 *Scenario 2 – hybrid instrument (deductible interest in New Zealand; non-taxable dividend in Australia)*



3.27 NZ Co claims a deduction in New Zealand for the interest paid under the hybrid instrument. However, the coupon is treated as a dividend in Australia and is exempt from income tax on receipt by Oz Co. Therefore, Oz Co has nil taxable income but an accounting profit of $10m. It is this asymmetric tax outcome that is considered to be tax base erosion and which is the target of the proposed hybrid financial instrument rule.

3.28 However, when the profit derived by Oz Co is paid by way of dividend to its shareholder, the dividend is unfranked. Assuming (as above) the shareholder is subject to a 37% marginal tax rate in Australia, shareholder has tax to pay of $3.7m with no franking credits to offset the liability. The total tax paid in this scenario is $3.7m, which is identical to scenario 1, meaning that there has been no net erosion of tax revenues collected.

3.29 The recommendations put forward by the OECD are more easily justified when hybrid financial instruments are used between jurisdictions that operate a classical dual tax system. Less so, when imputation applies.

3.30 One response to this argument is that Oz Co can choose to not fully distribute its profits meaning that there potentially a permanent deferral of the tax impost at shareholder level. However, the converse also applies, in that to the extent a company does fully distribute its retained profits, the application of the hybrid financial instrument rule would result in double taxation – once in New Zealand by way of the denial of the tax deduction on the interest payment and again in Australia at the ultimate shareholder level. This impact on trans-Tasman investment should not be overlooked in considering the appropriateness of the OECD proposals to the New Zealand context.

4.0 CONCLUSION

4.1 BNZ is pleased to provide this submission and the information it contains. BNZ is available to discuss any issues raised.

4.2 Should IR have any questions in relation to this submission, please contact:

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11 November 2016

Addressing hybrid mismatch arrangements
C/- David Carrigan, Acting Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

Addressing hybrid mismatch arrangements – Government discussion document

We are writing in respect of the Government discussion document, *Addressing hybrid mismatch arrangements* (herein referred to as "the Paper"). We appreciate the opportunity to comment on the Paper.

Executive summary

From a policy perspective, our primary submission points are the following.

- A de minimis rule should be included to ensure that the proposals (and the resulting compliance costs) are correctly targeted.
- We are not supportive of the proposals to deny a deduction for a New Zealand business' foreign branch losses. This proposal would likely discourage the use of a common structure utilised by New Zealand businesses when expanding overseas.
- The denial of an immediate deduction for a New Zealand business' foreign branch losses would be untenable without an active income exemption.

In addition to the above, we also have the following general submission points.

- The Paper is long, complicated and technical in nature.
- The Paper should include an executive summary to assist readers in understanding the proposals.
- We endorse submissions made by the Corporate Taxpayer Group and support the detail included in their submission, particularly comments in relation to the proposal's application date and grandparenting.
- The consultation period for the Paper overlapped with a number of other outputs from Inland Revenue which required more immediate analysis.
- Further consultation should take place with respect to refining the proposals (including draft legislation).
- Separate consultation should take place in relation to the inclusion of a de minimis rule and an active income exemption (if Officials agree with our submissions).

Given the complexity of the Paper we have only provided high level submission points and have not submitted on the detail.

General comments

The Paper is an 83 page document discussing New Zealand's implementation of the OECD's recommendations included in their 454 page paper entitled *Neutralising the Effects of Hybrids Mismatch Arrangements*. The Paper is long, complicated and technical in nature. The Paper does not include an executive summary to assist readers in understanding proposals recommended by Officials. A summarised table of the proposals and common examples of where they could impact would be useful.

De minimis rule

The complexities of the proposals are likely to add significant compliance costs for affected taxpayers. Compliance costs will be incurred up-front in understanding the proposals and how they affect the taxpayer's business, and then on an on-going basis in ensuring continued compliance. Given their complexity, if the proposals are to proceed, we do not agree that all taxpayers should be subject to the proposals.

To ensure the proposals and the resulting compliance costs are correctly targeted, we submit that Officials should consider a de minimis rule. We recommend a rule to carve-out smaller sized taxpayers or small transactions that do not pose a material risk to New Zealand's tax base. We recommend that the de minimis rule is based on the taxpayer's overall turnover for smaller taxpayers (e.g. under $80 million) and based on transaction value for larger taxpayers (e.g. under $1 million of relevant income or expenditure).

Deductible hybrid payments

Foreign branches of New Zealand businesses

Chapter 8 (Deductible hybrid payments) proposes to deny a deduction for a New Zealand business' foreign branch losses (except against dual inclusion income from the same country). This proposal may detrimentally affect New Zealand businesses with foreign branches given the compliance costs that they will face, the change in the ability to use foreign losses against New Zealand income and the risk that certain losses will never be able to be used. We consider that this proposal, in the absence of an active income exemption, would not serve New Zealand's best interest. The use of foreign branches by a New Zealand business is common practice in the initial stage of operating in another country, particularly for SMEs who have a greater tendency to expand to another country via a branch structure due to lower compliance costs. The use of the foreign branches by a New Zealand business would therefore be discouraged by this proposal. This would be detrimental to New Zealand as, with the New Zealand market being so small, businesses must be able to easily expand offshore to grow the New Zealand economy.

Accordingly, we are not supportive of the proposals to deny a deduction for a New Zealand business' foreign branch losses.

Active income exemption

On page 65 of the Paper, Officials specifically call for submissions on whether the denial of a deduction for foreign branches losses against New Zealand income should be matched by an exemption for active income earned through foreign branches. We are strongly supportive of an exemption for active income earned through a foreign branch, especially if the

proposals in relation to foreign branches proceeds and our de minimis rule submission is not accepted by Officials.

We consider that an exemption for active income earned through a foreign branch would alleviate some of the issues caused by the deductible hybrid payment proposals. Despite this, we note that the proposals would still increase the overall compliance costs faced by New Zealand businesses using the foreign branch structure.

Based on this, it is our view that the denial of an immediate deduction for a New Zealand business' foreign branch losses would be untenable without an active income exemption.

Corporate Taxpayer Group

During the process of reviewing the Paper, we have liaised with the Corporate Taxpayer Group ("the Group"). While submission points included in our submission are limited, we endorse submissions made by the Group and support the detail included in their submission.

In particular, we are supportive of the following submissions made by the Group.

- A grandparenting period of three years following the date of enactment would be appropriate for existing arrangements, to enable a transition to the new rules.
- New Zealand should at a minimum have a similar implementation date for the hybrid rules to Australia and, if there is a delay in their hybrid rules being enacted, New Zealand could consider delaying the implementation date until similar proposals are in force in Australia.

Other comments

Deadline extension

We are appreciative that Officials have considered it appropriate to extend the Paper's submission deadline, however we note that the consultation period for the Paper overlapped with a number of other outputs from Inland Revenue which required more immediate analysis.

For example, the Supreme Court's judgement in *Trustpower v Commissioner of Inland Revenue* was released on 27 July 2016 and the updated draft interpretation statement on the deductibility of feasibility expenditure was released on 14 October 2016. The Commissioner's case impact statement on the Supreme Court case provides that tax positions taken after the date of the judgement should take into account the *Trustpower* decision. As a result, the analysis of feasibility expenditure for income tax returns currently being prepared has been prioritised by many taxpayers over hybrid mismatch arrangements proposals which are not expected to affect income tax returns currently being filed (i.e. hybrid mismatch arrangements are expected to apply to payments made after the taxpayer's first tax balance date following enactment).

Further consultation

The Paper is inherently complex, which means not all scenarios can be modelled for. We consider that further work is required to determine the impact of proposals on all likely scenarios. We therefore submit that further consultation should take place with respect to refining the proposals (including draft legislation).

Additionally, if Officials agree with our submissions points, we submit that separate consultation should take place in relation to the inclusion of a de minimis rule and active income exemption.

For any queries in relation to this submission, please don't hesitate in contacting Robyn Walker (04 4703615 or robwalker@deloitte.co.nz) or Brad Bowman (09 303 0885 or bbowman@deloitte.co.nz).

Yours sincerely

Robyn Walker
National Technical Director
for Deloitte Limited (as trustee of the Deloitte Trading Trust)

#010

Corporate Taxpayers Group

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11 November 2016

Addressing hybrid mismatch arrangements
C/- David Carrigan, Acting Deputy Commissioner
Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

ADDRESSING HYBRID MISMATCH ARRANGEMENTS

The Corporate Taxpayers Group (the "Group") is writing to submit on the discussion document "*Addressing hybrid mismatch arrangements*" (the "Discussion Document").

The Group is appreciative of the opportunity to submit on this Discussion Document and the time spent by Officials to date in discussing these proposals with us.

Summary of our submission

The key points in our submission are:

General comments

- New Zealand should not to proceed with the wholesale adoption of the OECD recommendations in relation to Hybrids, as:

  - the solutions proposed by the OECD are complex;
  - the number of instances of improper use of hybrid arrangements appears to be limited;
  - the proposed solution will often require taxpayers to seek foreign tax advice when applying the rules;
  - there is significant resource cost and opportunity cost involved in advancing these proposals.

  The better approach would be for New Zealand to consider targeted reform with rules addressing particular areas of concern.

- If it is not possible to apply a more targeted approach, the focus should be on making these rules as simple as possible and remove any unintended consequences. Further, if the rationale for a comprehensive solution is based on alignment with the OECD, then

as a minimum we need to ensure that New Zealand aligns to the timing of adoption of other relevant jurisdictions, their transition periods and any grandfathering provisions.

- There are a number of ambiguities / unanswered questions with these proposals that are detailed in Appendix Two of this submission. Before proceeding further with these proposals, we suggest that these questions are considered further. We would like to arrange a meeting with Officials to discuss these further.

Economic analysis

- Some of the economic claims made in Chapter 3 of the discussion document appear questionable and we would be interested in seeing what economic analysis has taken place in relation to these claims. We would be interested in receiving clarification from Officials on this.

De-minimis threshold

- Given the complexity of the proposals, we believe it would be appropriate that a de-minimis threshold is introduced where transactions below a certain threshold are not subject to the hybrid rules. This will ensure that the rules are more appropriately targeted at transactions where the tax revenue at stake justifies the compliance costs imposed on the business.

Further consultation and timeframe

- This discussion document contains significant and complex tax proposals that require a lot of time to consider adequately. The timeframe for making submissions on the discussion document has not allowed sufficient time for the tax community to fully consider the wide-ranging impacts of the proposals.

- The current timeframe for advancing these proposals should be extended to enable sufficient time to properly consider and address the issues, compare New Zealand's position with other countries and reduce the risk of unintended consequences.

- In addition, as submitted below, these proposals warrant the introduction of an active income exemption for branches, which requires an additional consultation process.

- While the discussion document attempts to articulate proposals, it is only once proposals are put into draft legislation that taxpayers can really begin to analyse and appreciate how the proposals may impact on their business arrangements. Therefore we strongly recommend that an exposure draft with draft legislation should be released for further consultation prior to including these proposals in a Tax Bill.

General rule for introduction

- We do not agree with the proposed application date for these proposals. It is important that New Zealand's implementation date is not in in advance of other OECD member nations, particularly Australia's.

- New Zealand should not be an early adopter of these proposals because if we do act early, we risk a material increase in compliance costs as taxpayers will need to analyse their arrangements and the current foreign tax treatment, monitor legislative changes in foreign jurisdictions, and adopt different treatments in New Zealand as changes progress overseas.

- We submit that New Zealand should at a minimum have a similar implementation date for the hybrid rules to Australia and if there is a delay in their hybrid rules being enacted, New Zealand should consider delaying the implementation date until similar proposals are in force in Australia.

Grandparenting and transitional period

- In the Group's view, a grandparenting period of three years following date of enactment would be appropriate for existing arrangements, to enable a transition to the new rules.

- Even if Officials do not accept a grandparenting period for all existing arrangements, there is a good case for grandparenting in specific circumstances. Given our close ties to Australia, if Australia includes some form of grandparenting treatment for regulatory capital, in the Group's view it would be necessary for New Zealand to apply similar treatment.

Timing differences

- We agree with Officials that the Australian Board of Taxation approach would be preferable for New Zealand. This approach has advantages over the OECD approach as it is more certain by providing objective criteria for determining when there is a timing mismatch. In addition, it is a more reasonable approach as it allows denied deductions to be carried forward.

- The discussion document does not consider how the rules may apply in situations where NZ recognises the treatment of interest and foreign exchange as a single item of Financial Arrangement income under our Financial Arrangement rules, as compared to other countries that might treat these amounts separately. We submit that further consideration needs to be given to this issue, and Officials need to provide further guidance on this in any further consultation on these proposals.

Taxation of FIF interests

- Our primary submission is that FDR, cost and DRR methods should not be altered in response to the hybrid proposals. This goes beyond the scope of the core policy concern and should not be an area of focus.

- If the proposals in this area, do proceed we suggest that the preferred approach should be to deny the ability to use the FDR, cost and DRR methods for shares on which any dividend would be deductible to the payer and simply tax the dividend. This appears to be the least complex and most straightforward to apply. However, we have not considered these options in detail.

Regulatory capital

- At a minimum, given our close ties to Australia, if Australia either excludes regulatory capital or regulatory capital is subject to grandfathering treatment, New Zealand should follow a similar approach.

- Even if Australia does not adopt grandfathering treatment for regulatory capital, there are good reasons for adopting grandfathering treatment to provide financial institutions with a transitionary period to adapt to the new rules.

- There should be a grandparenting period of 5 years from the effective date (assuming the proposals are enacted in 2018). In addition, grandparenting treatment should

apply to all regulatory capital issued prior to the release of this discussion document as prior to this date, there was no certainty on the position that Officials would take in respect of regulatory capital.

Carry-forward of denied deductions

- We do not support the existing loss carry forward rules being used as a basis for allowing the carry forward of disallowed deductions under the hybrid rules. This is because the policy behind the existing loss carry forward rules is different to those applying to the hybrid rules. In addition, the Group has concerns around the continued appropriateness of the existing loss carry-forward continuity threshold.

- To prevent double taxation, if excess dual inclusion income is returned in a subsequent year, and deductions have been denied in a prior period, it is appropriate that this be offset to prevent double taxation, regardless of changes in ownership in excess of 51% during the total period.

Dual inclusion income

- As dual inclusion income is a fundamental concept to these proposals, we believe that further consideration needs to be given to what is and what is not dual inclusion income. Officials need to provide further guidance on this concept in any further consultation on these proposals.

- We do not agree with the proposal to depart from the OECD's recommendations in relation to CFC income as dual inclusion income.

Carry forward / reversal of defensive rule income

- We agree that there should be some carry forward of defensive rule income. A "reversal" rule for the application of the defensive rule is the most straightforward and least complex approach. Despite this, we submit that the best way forward would be to allow taxpayers a choice of options.

Reverse Hybrids

- In relation to Recommendation 4, the Group strongly submits that CFC income should be respected as income of the payee to ensure there is no denial of a deduction where the income is recognised in the parent of the reverse hybrid as CFC income.

- We do not consider that the suggested changes to the CFC regime in paragraph 7.19 (Recommendation 5.1) in the Discussion Document are required given the breadth of New Zealand's CFC regime and the complexity this will give rise to.

Deductible hybrid payments – Application to branches

- If the proposal to deny a deduction for foreign branch losses, do proceed it is critical that this is balanced by an active income exemption for foreign branch income.

- Further, aspects of these rules will be need to be clarified. In particular, clarification of when a loss offset by a foreign branch is "not possible" to enable losses to be offset against the income of a NZ entity.

Further detail on these submission points are included at Appendix One to this submission. A list of questions regarding the Discussion Document proposals are included at Appendix

Two. As noted above, we would like to arrange a meeting with Officials to discuss these questions.

Please contact us if you wish to discuss any of the matters raised in our submission further with us.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ Bank New Zealand
5. ASB Bank Limited
6. Auckland International Airport Limited
7. Bank of New Zealand
8. Chorus Limited
9. Contact Energy Limited
10. Downer New Zealand Limited
11. Fisher & Paykel Healthcare Limited
12. Fletcher Building Limited
13. Fonterra Cooperative Group Limited
14. General Electric
15. Genesis Energy Limited
16. IAG New Zealand Limited
17. Infratil Limited
18. Lion Pty Limited
19. Meridian Energy
20. Methanex New Zealand Limited
21. New Zealand Post Limited
22. New Zealand Racing Board
23. New Zealand Steel Limited
24. New Zealand Superannuation Fund
25. Opus International Consultants Limited
26. Origin Energy New Zealand Limited
27. Pacific Aluminium (New Zealand) Limited
28. Powerco Limited
29. Shell New Zealand (2011) Limited
30. SKYCITY Entertainment Group Limited
31. Sky Network Television Limited
32. Spark New Zealand Limited
33. T & G Global Limited
34. The Todd Corporation Limited
35. Vodafone New Zealand Limited
36. Westpac New Zealand Limited
37. Z Energy Limited
38. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE: DETAILED SUBMISSION POINTS

1. General comments

Scope of proposals

1.1 The Group agrees that some changes to the rules may be necessary, as the world in which businesses operate has evolved – and so must New Zealand's tax settings. However, we question whether the proposed solution to the issue of hybrid mismatch arrangements is proportionate with the problem. We understand why it may be difficult to estimate the impact hybrid arrangements are having on the New Zealand tax base, but in absence of such evidence, there is no justification for the complexity that these proposals would introduce.

1.2 Paragraph 3.26 of the Discussion Document notes that "*any new rules addressing hybrid mismatch arrangements should be effective from a policy perspective, but be as simple as possible to comply with and administer*". By their very nature, given these proposals are so complex (even for experienced tax professionals) and require taxpayers to consider the tax treatment in another jurisdiction in order to determine the New Zealand tax treatment, this will be very difficult to achieve. This complexity is likely to give rise to unintended or adverse outcomes that are not subject to the same policy concerns as hybrid mismatch arrangements.

1.3 There is a good case for New Zealand not to proceed with the wholesale adoption of the OECD recommendations in this area, given that:

- the solutions proposed by the OECD are complex;
- the number of instances of improper use of hybrid arrangements appears to be limited;
- the proposed solution will often require taxpayers to seek foreign tax advice when applying the rules
- There is significant resource and opportunity costs involved in advancing these proposals.

The Group is not advocating for double non-taxation. However, in the Group's view, a better approach would be for New Zealand to consider targeted reform with rules addressing particular areas of concern. Officials should identify particular arrangements or structures they find offensive from a New Zealand revenue protection and welfare maximising point of view (as they have done in the discussion document, for example Australian limited partnerships) and design rules to combat those, using the OCED recommendations as a framework.

1.4 If it is not possible to apply a more targeted approach, the focus should be on making these rules as simple as possible and remove any unintended consequences. This is the focus of our submission points on the detailed proposals.

1.5 We consider that there are a number of unanswered questions with these proposals which are detailed in Appendix Two of this submission. These arise from the complexity of the discussion document proposals. Before proceeding further with these proposals, we suggest that these questions will need to be considered further before proceeding to the draft legislation stage. We would welcome a meeting with Officials to discuss these further.

Consideration of foreign tax rules

1.6 It is clear that taxpayers will need to seek foreign tax advice when applying the hybrid rules. We consider that it is a troubling development that in order to determine NZ tax treatment, a taxpayer will be forced to obtain tax advice in a foreign jurisdiction. The cost of obtaining tax advice in other jurisdictions can be excessive compared to New Zealand, and this will place an additional burden and increased compliance costs on businesses. In particular, tax advice will need to be sought on many cross border instruments or entities, as it may not be until the tax treatment in both jurisdictions is fully known, that a NZ taxpayer will know whether the instrument or entity is a hybrid and in the scope of the rules.

1.7 The burden placed on New Zealand businesses to obtain foreign tax advice is another reason for NZ not to adopt the full suite of hybrid proposals. It is also unclear how the IRD would plan to audit such transactions unless they also obtain their own foreign tax advice.

De-minimis threshold

1.8 As noted above, the complexity of proposals are likely to add significant compliance costs for impacted taxpayers. We submit that given this, there is merit in a de-minimis threshold being introduced so that transactions below a certain value would be exempt from the rules.

1.9 In the Group's view, the compliance costs of applying the hybrid rules are likely to be much higher than the potential revenue collected by IRD in many instances. Given that the risk to the tax base is lower on smaller transactions, it makes sense that the hybrid rules would be targeted only at higher-value transactions. We envisage that if the transaction value was below a particular level (e.g. $1 million), the hybrid rules would not apply. This will ensure that the rules are more appropriately targeted at transactions where the tax revenue at stake justifies the compliance costs imposed on the business.

Economic analysis

1.10 Some of the economic claims made in Chapter 3 of the discussion document appear questionable and we would like to see what economic analysis has taken place in relation to these claims. Examples of these economic claims are:

- Paragraphs 3.4 and 3.5 note that organisations taking advantage of hybrid mismatch opportunities may lead to "welfare losses" and a "sub-optimal allocation of capital". Given it is widely acknowledged by economists that payment of tax gives rise to a deadweight (welfare) loss to society, it is questionable whether paying less tax actually gives rise to a welfare loss.

- Likewise, paragraph 3.8 suggests the current situation "reduces worldwide welfare". However, if tax on the whole results in a deadweight loss, how can increasing corporate tax be a good thing in terms of increasing worldwide welfare? The only way to reduce the impact on NZ's overall economic welfare would be to introduce tax cuts to compensate for the increased tax collected in respect of hybrid entities or mismatch arrangements (if these proposals proceed), is this what paragraph 3.8 infers we should do?

- Paragraph 3.19 hypothesises that investors using hybrids may be crowding out investors who would have otherwise invested via equity (and paid more NZ tax)

so NZ may be currently missing out on additional tax through the use of hybrids. However, it is likely that foreign investors will be seeking a certain after-tax hurdle return from their investment in NZ. If the NZ tax increases, they may pass this cost on to NZ consumers/customers or even pull out of NZ altogether if the hurdle is not met. This is the flip side to welcoming more foreign investment by keeping taxes on foreign investors lower (given NZ is a capital importing country).

- Para 3.27 seems to wrap all of the preceding analysis into a conclusion that companies that exploit hybrid mismatch rules are "subsidised" currently and that eliminating this misallocation (i.e. taxing more) will "increase worldwide efficiency", leading to "higher worldwide incomes – which NZ will likely share in". It is not clear how increasing the NZ tax take will lead to an increase in NZ's share of worldwide income.

Further consultation and timeframe

1.11 It is the Group's view that the current timeframe for advancing these proposals should be extended. Given the complexity of the proposals, more time should be invested into the policy development process to ensure that Officials and taxpayers can properly consider the implementation of the proposals. As noted above, this is particularly important given that the exact implications of the proposals are yet to be fully understood and fleshed out. In the Group's view, it is crucial that time is taken to properly consider and address the issues and compare New Zealand's position with that of other countries and debate some of the more complex issues associated with these proposals.

1.12 It is worth noting that the original draft UK legislation on hybrids, was 69 pages long. Even though the UK rules are not effective until 1 January 2017, we understand that the draft legislation has already been amended several times to fix holes in it. This illustrates that the devil will be in the detail and it will be really hard to gauge the impact of rules in absence of draft legislation.

1.13 In light of this, we **strongly recommend** that an exposure draft with draft legislation should be released for further consultation prior to including these proposals in a Tax Bill. It is only once the exact parameters of the proposals are understood that taxpayers can properly test the proposals in their own factual scenarios and understand whether they give rise to appropriate outcomes. Releasing an exposure draft will increase the likelihood that any unintended consequences/issues can be fixed before the proposals are introduced into parliament. It is very difficult to effect material change in legislation through the select committee process.

1.14 Consultation of this nature is not unprecedented in respect of tax legislation and will often occur with other types of legislation. In respect of tax legislation, Officials consulted with the Group and other stakeholders on the rules for accommodation allowances introduced in the Taxation (Annual Rates, Employee Allowances and Remedial Matters) Act. The Group would be pleased to provide feedback on an exposure draft (in confidence), prior to inclusion in a Tax Bill. However, our first preference would be for the exposure draft to be released publically for all to consult on, particularly given the wide reaching impact of these proposals to all taxpayers with foreign branches.

2. General rule for introduction

Effective date

2.1 The proposed application date is noted in paragraph 11.22 of the Discussion Document:

> *"The impact of the proposals will in most cases be able to be established now, by reference to the Final Report. We consider that the period from introduction of the relevant legislation to its enactment should give taxpayers sufficient time to determine the likely impact and accordingly the effective date of the legislation should be its enactment date. In accordance with the OECD recommendation, the provisions would then apply to payments made after a taxpayer's first tax balance date following enactment."*

2.2 We do not agree that it is appropriate that these proposals should be effective from the date of enactment and apply to payments made after a taxpayer's first tax balance date following enactment. In particular, we do not agree with the conclusion reached by Officials that the impact of the proposals is well established by now. Given the overload of policy reform in the past couple of years, it is an inappropriate conclusion to expect taxpayers to have considered the OECD reports in any great detail (given the reports in are many hundreds of pages long), particularly before there was any indication of how they may be adopted in New Zealand.

2.3 If the Government considers that New Zealand must implement these rules, it is important that New Zealand's implementation date does not occur before other OECD member nations, particularly Australia's. New Zealand does not need to act fast as these is little to be gained from being the first to adopt these proposals. If New Zealand does act early, we risk a material increase in compliance costs as taxpayers will need to analyse their arrangements and the current foreign tax treatment, monitor legislative changes in foreign jurisdictions, and adopt different treatments in New Zealand as changes progress overseas.

2.4 For example, consider a trans-Tasman hybrid mismatch arrangement with a D/NI outcome where a New Zealand entity is the payer and an Australian entity is the recipient. Under existing rules, payments are treated as deductible interest in New Zealand but a non-taxable dividend in Australia. The tax treatment of this arrangement would change over the life cycle of the financial instrument. In Year 1, if the hybrid rules are in force in New Zealand but not Australia, New Zealand would deny the deduction. In Year 3, if Australia moves to tax the dividend, the payment would be deductible in New Zealand.

2.5 In addition, some of the proposed rules are not applicable if the overseas jurisdiction has implemented hybrid rules (i.e. the imported mismatch rule). Adopting before other countries could therefore significant increase compliance costs in New Zealand in the years before other countries adopt that would not otherwise arise.

2.6 These examples illustrate that having rules come into effect in New Zealand ahead of other jurisdictions will result in significant changes in outcomes and unnecessary complexity and uncertainty. Given this, it is important that New Zealand aligns itself with other jurisdictions, in particular Australia, both in respect of key issues such as regulatory capital (the Group understands this issue is causing delay of these proposals in Australia) and the implementation date.

2.7 The current intended start of the hybrid measures in Australia is 1 January 2018 or 6 months after legislation has been passed. We suggest that Officials monitor developments in Australia and if there are delays in their hybrid rules being enacted, consider delaying the implementation date for the hybrid proposals in New Zealand until similar proposals are in force and bedded down in Australia.

Grandparenting and transitional period

2.8 We do not agree with the general proposition that there should be no grandparenting for these proposals. Significant investment decisions have been made based on existing settings and a lot of these arrangements involve external commitments (not necessarily internal group arrangements) that cannot be easily unwound. In the Group's view, a minimum grandparenting period of three years following date of enactment would be appropriate for existing arrangements (with potentially a longer grandparenting period for regulatory capital), to enable a transition to the new rules.

2.9 Even if Officials do not accept a grandparenting period for all existing arrangements, there is a good case for grandparenting in specific circumstances. One such instance where grandparenting treatment is warranted is regulatory capital. Again given our close ties to Australia, if Australia includes some form of grandparenting treatment for regulatory capital, in the Group's view it would be necessary for New Zealand to apply similar treatment.

3. Implementation of OECD recommendations in New Zealand

3.1 The next section in our submission considers the more technical aspects of the proposals. Given the sheer scope of these proposals, we do not comment on all the submission points in the discussion document, but focus on those that are of greater interest to our members.

4. Timing differences

4.1 As summarised in paragraph 5.22 and 5.23 of the Discussion Document, the OECD Final Report suggested approach for timing differences is:

> *"The Final Report suggests that a deduction should not be denied if the payment giving rise to the deduction is included in income in an accounting period that begins within 12 months of the end of the period in which the deduction is claimed. If this test is not met, the payer should still be entitled to a deduction if it can satisfy the tax authority that there is a reasonable expectation that the payment will be made within a reasonable period of time, and once made will be included in ordinary income. A reasonable period is one that might be expected to be agreed between arm's length parties. Final Report Example 1.21 applies these principles.*
>
> *The Final Report does not provide for any denied deductions to be carried forward and allowed if and when the payee does recognise income."*

4.2 The Australian Board of Taxation approach for timing differences is (as summarised in paragraph 5.25 of the Discussion Document):

> *The Australian Board of Taxation Report recommends a different approach. It suggests that a gap of up to three years between deduction and inclusion should not attract operation of the rule, whereas a longer*

gap should mandatorily do so. It also suggests that any deduction denial should reverse when and if the payee recognises the corresponding income. This is essentially a carry-forward loss proposal. The proposal seems to mirror what would happen in the case of inclusion under the defensive rule. If the amount of a deduction in a payer jurisdiction were included in the payee's income under the defensive rule, and the payment giving rise to the income inclusion was later received, it would not be appropriate to tax the payment again, and rules against double taxation would generally achieve this. This supports the Board of Taxation carry-forward proposal in relation to the primary rule.

4.3 The Discussion Document seeks submissions on (Submission point 5C, page 42):

- *Whether the approach recommended by the Australian Board of Taxation would be an acceptable one for New Zealand;*
- *What alternatives might be better to deal with timing mismatches;*
- *What thresholds should apply to determine when the rule would apply to a difference caused by different income and expenditure rules."*

4.4 We agree with Officials that the Australian Board of Taxation approach would be preferable for New Zealand. This approach has advantages over the OECD approach as it is more certain by providing objective criteria for determining when there is a timing mismatch. In addition, it is a more reasonable approach as it allows denied deductions to be carried forward. It also seems sensible that a gap of up to three years between deduction and inclusion should not attract operation of the rule (particularly factoring in time delay between deductions being incurred, tax returns being filed, assessments being made of returns filed and any adjustments required being factored into required New Zealand provisional tax payments). For these reasons we support the Australian approach being adopted in relation to timing mismatches.

4.5 We comment later in the submission on the rules for carrying forward a deduction that has previously been denied.

4.6 The discussion document does recognise that the payee and payer countries may recognise income and expenditure from a financial instrument on a different basis (e.g. accrual or cash basis). However, it does not appear to consider how the rules may apply in situations where NZ recognises the treatment of interest and foreign exchange as a single item of Financial Arrangement income under our Financial Arrangement rules, as compared to other countries that might treat these amounts separately. We submit that further consideration needs to be given to this issue, and Officials need to provide further guidance on this in any further consultation on these proposals.

5. Taxation of FIF interests

5.1 Paragraph 5.48 and 5.49 of the Discussion Document notes:

"If a New Zealand resident holds shares subject to the FIF regime, and accounts for those shares using the fair dividend rate (FDR), cost or deemed rate of return (DRR) method, the dividends on those shares are not taxable. Instead the resident returns an amount of deemed income. Dividends are only taxable if the holder uses the comparative value (CV) or attributable foreign interest (AFI) method (note that when those two methods are being used, if the dividend is deductible in the

foreign country it will not be exempt in New Zealand even if the shareholder is a company).

FIF taxation therefore presents at least two problems for applying Recommendation 1.

- *The non-resident payer of a deductible dividend to a New Zealand payee, if resident in a country with the hybrid rules, will not know how a New Zealand taxpayer of ordinary status would treat the dividend, and therefore will not know whether, or to what extent, it is denied a deduction for the dividend by the primary response in its own country.*

- *When the New Zealand payee is applying the defensive rule (in a case where the non-resident payer of a deductible dividend has not been denied a deduction), if the payee is not applying the CV or AFI method, the payee will need to determine how much of the dividend has not been taxed, in order to know how much additional income to include."*

5.2 Paragraph 5.50 of the Discussion Document notes the possible solutions:

- *deny the FDR, cost and DRR methods to shares on which any dividend would be deductible to the payer. This would be similar to the existing requirement to use the CV method for a non-ordinary (generally, debt-like) share (section EX 46(8));*

- *include a deductible dividend in the holder's income, in addition to income already recognised under the FDR, cost or DRR method. This would be similar to the exclusion of deductible dividends from the general exemption for foreign dividends received by New Zealand companies in section CW 9 (though this exclusion does not apply to interests accounted for under the FDR, DRR or cost method);*

- *include a deductible dividend in the holder's income only to the extent that it exceeds the income otherwise recognised on the shares. This is somewhat similar to the concept of a top-up amount (defined in section EX 60) that applies when a person uses the DRR method.*

5.3 Submission point 5E notes (at page 42):

"Submissions are sought on which of these FIF approaches would be preferable and why, and whether there is another better approach."

5.4 Our primary submission is that these FIF methods should not be altered in response to the hybrid proposals. This goes beyond the scope of the core policy concern and should not be an area of focus.

5.5 We note that there are a number of issues Officials will need to consider if they are to advance any of the proposed solutions noted above. In particular, ensuring that these rules do not inadvertently capture portfolio investments, including those held by PIEs and other widely held investment vehicles.

5.6 If one of these options does proceed, we suggest that the preferred approach should be the one that is the least complex and most straightforward to apply. Our preliminary view is that the first option appears to best meet this criteria however we would welcome further discussion with Officials on this if it is to be advanced.

6. Regulatory capital

6.1 Submission point 5H notes (at page 45):

> *"Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital."*

6.2 On this issue, paragraphs 5.59 and 5.60 of the Discussion Document note:

> *"The UK proposes to take up the option to exclude bank regulatory capital instruments from its regime in certain circumstances (see discussion at Chapter 8 of Tackling aggressive tax planning (HM Treasury and HMRC, December 2014). However, we understand that the UK has existing anti-hybrid rules that apply to bank regulatory capital. The Australian Board of Taxation Report sought an extension of time to report on this issue.*
>
> *It is not proposed that bank regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand."*

6.3 It is disappointing that Officials have provided no rationale for the proposed position in respect of regulatory capital. It makes it very difficult for stakeholders to consider the appropriateness of the position without understanding the rationale for such. We believe it would be in New Zealand's best interests to exclude regulatory capital from the scope of these proposals, as the inclusion of such is likely to increase the cost of capital in New Zealand.

6.4 We submit that in this area, New Zealand should closely monitor what Australia is doing. At a minimum, given our close ties to Australia, if Australia either excludes regulatory capital or regulatory capital is subject to grandfathering treatment, New Zealand should follow a similar approach.

6.5 Even if Australia does not adopt grandfathering treatment for regulatory capital, there are good reasons for adopting grandfathering treatment to provide financial institutions with a transitionary period to adapt to the new rules. We understand that it can be difficult to wind up regulatory capital arrangements and that to do so will often require Reserve Bank approval (and there can be a number of hurdles to be met before such approvals are granted).

6.6 In light of this, we submit that there should be a grandfathering period of at least 5 years from the likely effective date (assuming these proposals are enacted in 2018). This would allow an orderly unwind of existing instruments, supporting investor confidence. This would ensure that the cost of capital is not pushed up through the need for multiple issuers to withdraw their issues and go to market for replacement funding at a similar time.

6.7 Any grandparenting treatment should apply to all regulatory capital issues prior to the date IRD released this discussion document. Prior to this date there was no certainty about how the IRD would land on regulatory capital, particularly since other jurisdictions are actively considering or applying carve outs for regulatory capital from their hybrid proposals.

6.8 In summary, we submit that at the very least, there should be some grandfathering treatment for regulatory capital, subject to any further developments in Australia.

7. Carry-forward of denied deductions

7.1 Submission point 6A notes (at pages 50-51):

> *"Submissions are sought on whether there are any issues with using the rules for the carrying forward of tax losses as a basis for the treatment of carrying forward disallowed deductions."*

7.2 We do not support the existing loss carry forward rules being used as a basis for allowing the carry forward of disallowed deductions under the hybrid rules. In the Group's view, there are deficiencies with our existing loss carry forward rules and these operate in some instances to reduce the incentive for businesses to innovate and take risks and restricts the ability to introduce new capital into a business. Arguably, the loss carry forward rules should be more generous and should be not be used as the basis for loss carry forward for hybrid mismatch arrangements.

7.3 In addition, the purpose of our existing loss carry forward rules are designed to ensure that the same ultimate owner who bears the loss is ultimately able to utilise it.

7.4 In the context of hybrid mismatch arrangements, the same policy concerns are not as evident. If excess dual inclusion income is returned in a subsequent year, and deductions have been denied in a prior period, it is appropriate that this be offset to prevent double taxation, regardless of changes in ownership in excess of 51% during the total period. If Officials have concerns about loss trading, an anti-avoidance rule could be included in the rules to specifically combat this.

8. Carry-forward / reversal of defensive rule income

8.1 Paragraphs 6.25 to 6.27 of the Discussion Document note:

> *"The Final Report does not propose a carry-forward rule for the application of the defensive rule. This creates a potential for over-taxation in a scenario where the defensive rule is applied to include extra income in the payee country and excess dual inclusion income arises in a later year.*
>
> *A solution to this problem may be to provide for a "reversal" rule whereby the application of the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income.*
>
> *Alternatively, the defensive rule could be limited so that income is only included to the extent that the disregarded payment deduction is offset against non-dual inclusion income in the payer jurisdiction. In the event that there is no non-dual inclusion income that the payment can be offset against, the income inclusion could be suspended until non-dual inclusion income is present. Unlike the reversal approach, this option would require the payee country tax authority and payee jurisdiction taxpayers to be aware of the level of non-dual inclusion income being earned in the payer country."*

8.2 Submission point 6C notes (at pages 52-53):

> *Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in this regard, and which approach would be best to take."*

8.3 We agree that there should be some carry forward of defensive rule income. A "reversal" rule for the application of the defensive rule is the most straightforward and least complex approach. Despite this, we submit that the best way forward would be to allow taxpayers a choice of options. Where the taxpayer is aware of the level of non-dual inclusion income being earned in the payer country, they could elect to limit the application of the defensive rule. This ensures that the taxpayer is not forced to report income in the payee country which they know will ultimately be reversed.

8.4 However, taxpayers may not have the information to identify the level of non-dual inclusion income in the payer country or choose not to apply this approach due to the greater complexity involved. In this instance, taxpayers should be able to elect to apply the "reversal rule" to reverse the application of the defensive rule in a later period. Allowing an election of options will provide the most flexibility to ensure that taxpayers are not subject to double taxation.

9. Dual inclusion income

General comments

9.1 Dual inclusion income is a fundamental concept in the context of hybrid entities and branches. We believe this requires further consideration as to what would be and would not be dual inclusion income. While this appears to be a simple concept, there are some complexities such as foreign exchange gains/losses on loans which is unclear how this would be treated.

9.2 We believe that further consideration needs to be given to what is and what is not dual inclusion income. Officials need to provide further guidance on this concept in any further consultation on these proposals. Until there is clarity on key concepts such as this, taxpayers face difficulties in understanding how these proposals might apply to their existing structures.

CFC income as dual inclusion income

9.3 Paragraph 6.28 of the Discussion Document notes:

> *"As with Recommendation 1, it is proposed that CFC income is not able to be included as dual inclusion income. This will avoid drafting a large amount of very detailed and targeted legislation, aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise."*

9.4 Submission point 6D notes:

> *"Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in relation to CFC income as dual inclusion income."*

9.5 We do not agree with the proposal to depart from the OECD's recommendations in relation to CFC income as dual inclusion income. Just because it is difficult and/or complex to include CFC income as dual inclusion income is not an excuse to depart from the OECD proposals, especially since the OECD recommendations are likely to achieve a more appropriate outcome.

9.6 If the Government proceeds with the full suite of hybrid proposals, it is important that we have a comprehensive regime that seeks to get the right overall outcomes, and not draw a line in a taxpayer unfavourable manner. While it could be argued that taxpayers who are impacted by this proposal could simply use an alternative structure, in many instances structures are locked in or simply cannot be re-structured.

10. Reverse hybrid rule

10.1 Chapter 7 of the Discussion Document deals with reverse hybrids which is an entity whose income is treated as:

- Derived by its investors in its establishment country;
- Derived by the entity in the investor country.

Recommendation 4

10.2 Recommendation 4 is described in paragraphs 7.6 to 7.7 of the Discussion Document:

> *"Recommendation 4 is when a D/NI payment is made to a reverse hybrid, and the payment would have been included in income if it were made directly to the investor; the payer country should deny a deduction for the payment. The Recommendation also applies if the payment would have given rise to a hybrid mismatch under the hybrid financial instrument rule if made directly to the investor. As with the disregarded payments rule, this rule can apply to any deductible payment.*
>
> *Taxation of an investor in its home country on a subsequent distribution by the reverse hybrid of the income does not prevent a payment being subject to disallowance under this Recommendation (Final Report, paragraph 156)."*

10.3 Submission point 7A notes (at page 56):

> *"Submissions are sought on whether there are any issues relating to implementing Recommendation 4 in New Zealand"*

10.4 These rules are extremely complex and we would question whether such a rule is a proportionate response to the issue. However, the Group strongly submits that CFC income should be respected as income of the payee to ensure there is no denial of a deduction where the income is recognised in the parent of the reverse hybrid as CFC income.

Recommendation 5.1 and 5.2

10.5 Chapter 7 of the Discussion Document includes Recommendations 5.1 and 5.2 which consider "CFC and other offshore investment regimes" and "taxation of reverse hybrids established in New Zealand" respectively.

10.6 According to paragraph 7.17 of the Discussion Document, recommendation 5.1 involves:

> *"This recommendation is for New Zealand to ensure that a payment to a CFC that is fiscally transparent in its establishment country with respect to the payment is caught by the CFC regime, that is, that it is taxed to New Zealand investors in the CFC, if those investors are subject to tax under the CFC regime. In this way, the CFC regime would be used to turn the reverse hybrid into an ordinary fiscally transparent entity, at least insofar as it allocates income to New Zealand investors."*

10.7 We understand that recommendation 5.1 is focused on D/NI outcomes and the proposals in para 7.19 are targeted at CFCs that are not recognising income in their own jurisdiction because they are treated as fiscally transparent, however a deduction has been taken in another jurisdiction for the payment to the CFC. We consider that payments giving rise to a D/NI outcome are likely to be passive income rather than active income. Given the breadth of New Zealand's CFC regime, passive income is likely to be taxed to the New Zealand parent of a reverse hybrid CFC under the current rules. We also consider that any active income is also likely to be taxed in the jurisdiction in which it is earned, meaning that any rule applied in this area is likely to have limited application. There could be situation where the reverse hybrid is largely active and the minor passive income is not taxed in jurisdiction or as New Zealand CFC income. However such cases are likely to be minor and are the result of a deliberate policy decision that income of a CFC will not be attributed to New Zealand where passive income is less than 5% of total income.

10.8 Given the complexity in drafting such a rule and its limited application, the Group submits that it should not be advanced as it is not considered required.

10.9 If the rule is adopted, the UK approach suggested at para 7.24 should be available to taxpayers that are able to ascertain whether a deduction has been denied in a payer jurisdiction. That is, taxpayers that can ascertain this information should not be disadvantaged.

11. Deductible hybrid payments – Application to branches

11.1 Submission point 8 (at page 65) notes:

> *"Submissions are sought on whether the denial of a deduction for foreign branch losses against New Zealand income should be matched by an exemption for active income earned through a foreign branch. This would put foreign branches of New Zealand companies in a similar New Zealand tax position to foreign subsidiaries.*
>
> *Submissions are also sought on any other aspect of the proposals relating to the implementation of the OECD's Recommendation 6 in New Zealand."*

11.2 If the proposal to deny a deduction for a foreign branch loss does proceed, we believe that an active income exemption for foreign branch income is critical to remove the complexity that will otherwise arise for those taxpayers that cannot simply restructure out of the use of a foreign branch.

11.3 Further, if these proposals do proceed, aspects of these will be need to be clarified. In relation to foreign branch losses, Paragraph 8.6 of the Discussion Document is not entirely clear on how these proposals will apply in practice. It is noted that "unless

it can be shown that such an offset is not possible", losses will have to be carried forward.

11.4 The question that arises is: When is an offset not possible? If we take an example of a New Zealand company with a branch in Australia, presumably this will be when there is no other Australian income to offset against. This could occur when the New Zealand resident entity does not have any other business operations in the other jurisdiction. However, what if the New Zealand entity later acquires a business in the other jurisdiction which it can offset the loss against? For example, consider an example where in Year 1, a New Zealand entity has no income in Australia to offset the loss incurred by its Australian branch. In Year 2, the New Zealand entity now has Australian income due to acquisition of another business. In Year 1, the NZ entity would not have known that it would have income in Australia in Year 2. Would this situation meet the criteria of being "not possible" for those losses to be offset against other Australian income? We require further clarification of how the Discussion Document proposals are intended to apply in this scenario.

APPENDIX TWO: FURTHER QUESTIONS

Para	Discussion Document extract	Issue
4.11	So, for example, a cross-border lease payment by a resident under an operating lease is not subject to this rule, even if the lessor country treats the lease as a finance lease.	Assume the same position if: • the lessee treats as a finance lease • both countries treat as a finance lease?
4.14	This rule only applies to payments between related parties (broadly, 25 percent or more common ownership) or under structured arrangements.	When investing into listed entities there are various rules prohibiting disclosure of information, even when greater than 50% is owned. How is this addressed? Also, when you own less than 50% outside the listed company scenario, how are restrictions of information to be addressed? How is 25% test to be measured (voting, dividend or some other basis?)
4.18	So, for example, if a hybrid entity makes a deductible payment to its foreign parent, and that payment is disregarded in the parent country because it treats the hybrid entity as a part of the parent, then *prima facie* the country where the hybrid is resident should deny a deduction for the payment. If it does not, the parent country should tax the payment. Neither response is required if the hybrid entity in the same year derives an equal amount of income which is taxed in both countries (that is, is dual inclusion income).	What happens if the branch is in losses, this seems to suggest that must have an equal amount of income?
5.12	Subject to two exceptions (considered below), countries only need to apply this rule to payments under financial instruments as characterised under their own domestic law. So, for example, a cross-border lease payment by a New Zealand-resident	If there is a finance lease in NZ, could this be a hybrid instrument?

Para	Discussion Document extract	Issue
	under a lease that is not a financial arrangement would not be subject to disallowance under this rule, even if the lessor country treats the lease payment as partially a return of principal under a finance lease.	
5.17	Only hybrid mismatches that arise as a result of the terms of an instrument are relevant. For example, if a New Zealand borrower pays interest to a related party who is tax-exempt, there will be no hybrid mismatch if the related party would have been taxable on the interest were it not tax-exempt. However, there will be a hybrid mismatch if the related party would not have been taxable on the interest if it were not tax-exempt (Final Report, Example 1.5).	How is this determined? How is the counterfactual established?. The tax treatment of an individual or a corporate or a trust or a collective investment vehicle (or various elections thereon) may all give different results. How is this addressed?
5.21/5.23 5.25	Where the payer and payee under a financial instrument are in different jurisdictions, it is not uncommon for them to recognise income/expenditure from the instrument on different bases. For example, a payer may be entitled to a deduction for a payment on an accrual basis, whereas a payee is taxable on a cash basis. In that case, there is a hybrid mismatch, which is *prima facie* subject to Recommendation 1. … The Final Report does not provide for any denied deductions to be carried forward and allowed if and when the payee does recognise income. … The Australian Board of Taxation Report recommends a different approach. It suggests that	What happens with the following: • Deduction is removed due to FX gains. • Deduction is accrual of a premium on the bond paid to another person (e.g. shareholder buys market debt for a premium, it will have deductions and no income to subsidiary company). • Deduction is due to capitalization of establishment costs. • Deduction reverses over life of instrument and is greater than 3 years?

Para	Discussion Document extract	Issue
	a gap of up to three years between deduction and inclusion should not attract operation of the rule, whereas a longer gap should mandatorily do so. It also suggests that any deduction denial should reverse when and if the payee recognises the corresponding income.	
5.37 & figure 5.3	The substitute payment is the premium portion of the amount paid by A Co to B Co for the transfer of the bond with accrued interest. The transfer is neither a financial instrument, nor a hybrid transfer. However, the premium is a payment in substitution for the payment of the accrued interest. It is deductible to A Co and treated as a capital gain to B Co, so it gives rise to a hybrid mismatch. On the facts of the example, the payment by A Co to B Co is a substitute payment because the payment of the coupon to the vendor would itself have given rise to a hybrid mismatch. The result would be the same if the coupon payment were taxable to the vendor. Accordingly, if the purchaser and vendor are related, or the sale is a structured arrangement, the payment of the premium will be subject to the hybrid mismatch rule.	What payment is taxable to B Co? How would B Co know, or the IRD know?
5.50	Possible solutions are to: • deny the FDR, cost and DRR methods to shares on which any dividend would be deductible to the payer. This would be similar to the existing requirement to use the CV method for a non-ordinary (generally, debt-like) share (section EX 46(8));	Is the CV treatment being proposed, or simply a move back to dividend only treatment? What happens if less than $50,000 FDR exemption applies? What if the NZ shareholder has no knowledge of the tax treatment of the dividend or whether the payer applied these rules?

Para	Discussion Document extract	Issue
5.50	• include a deductible dividend in the holder's income, in addition to income already recognised under the FDR, cost or DRR method. This would be similar to the exclusion of deductible dividends from the general exemption for foreign dividends received by New Zealand companies in section CW 9 (though this exclusion does not apply to interests accounted for under the FDR, DRR or cost method);	What is the logic to tax both FDR and the dividend? Why is the option of doing nothing not viable? What does the comment in Yellow highlight mean?
5.50	• include a deductible dividend in the holder's income only to the extent that it exceeds the income otherwise recognised on the shares. This is somewhat similar to the concept of a top-up amount (defined in section EX 60) that applies when a person uses the DRR method.	How are corporate restructures to be treated? What happens if the higher dividend does not occur each year?
5.52	Recommendation 1 could apply to an asset transfer involving a New Zealand party. For example, suppose a New Zealand resident purchases an asset from a related party on deferred payment terms, and is entitled to deduct a portion of the price as financial arrangement expenditure. If the vendor treats the entire amount as being from the sale of the asset, then there will be a hybrid mismatch, and the purchaser will be denied a deduction for the expenditure.	What if the vendor held the asset on revenue account (e.g. it was a significant item of trading stock) or was subject to capital gains tax in their jurisdiction? What if the asset is depreciable property? What if it is not known what the vendor's treatment is?
7.8/7.10	Many trusts – for example, most family trusts, do not have investors as such. For the purposes of this rule, an investor is any person to whom income is allocated by a reverse hybrid. So it	How is a control group determined for a Trust? (see also 7.30 below). How can a discretionary beneficiary have any control or exert any influence?

Para	Discussion Document extract	Issue
	would include any person who is allocated beneficiary income. …. The rule only applies if either: • the investor, the reverse hybrid and the payer are members of the same control group; or • the payment is under a structured arrangement to which the payer is a party.	Para 7.11 refers to the definitions in chapter 12, chapter 12 states that it needs to be defined?
7.9	The Recommendation will not apply if the reverse hybrid establishment country taxes as ordinary income the income allocated to the non-resident investor – for example, on the basis that the reverse hybrid is carrying on business in the establishment country.	How can a trustee always know what the foreign tax rules of a beneficiary is?
7.13	Countries should tax reverse hybrids established in their own country to the extent that their income is allocated to non-residents who are not taxable on the income because they are resident in a country that treats the reverse hybrid as fiscally opaque. This recommendation would only apply if the non-resident investor is in the same control group as the reverse hybrid.	If there is no control group, presumably there is no reverse hybrid?
7.16/12.5 /12.7	From the perspective of other jurisdictions making payments to New Zealand, we note that a foreign investor PIE would seem to be a reverse hybrid, depending on the treatment of the investors in their home countries (see Final Report, paragraphs 161 and 162). However, a payment to a foreign investor PIE would not be subject to disallowance in most cases, due to the scope limitation of Recommendation 4.	Why would a foreign investor PIE not have a purpose or effect of producing a hybrid mismatch?

Para	Discussion Document extract	Issue
	… The definition of a "structured arrangement" is set out in Recommendation 10 of the Final Report, and discussed in some detail. The core definition is that it is an arrangement where either: • the hybrid mismatch is priced into the terms of the arrangement; or • the facts and circumstances indicate that it has been designed to produce a hybrid mismatch. To incorporate this definition into New Zealand law, it is proposed to use the existing "arrangement" definition, and to define a structured arrangement as one where either: • the hybrid mismatch is priced into the terms of the arrangement; or • the arrangement has a purpose or effect of producing a hybrid mismatch.	
7.18	One way to address this would be to treat any person who has an interest in a CFC, as determined under subpart EX, to derive an amount of income from the CFC equal to the amount allocated to that person by the reverse hybrid for income tax purposes in its establishment country, and which is not taxed in the establishment country because of that allocation. This figure will already have been calculated by the CFC, and so should be readily available to the investor. In the case of an entity that is only partially transparent	What does this mean? How does this apply to ordinary dividends received by the reverse hybrid? Why will these amounts already have been calculated by the CFC and now available to the investor? Can we have a fully worked example what this is aimed at?

Para	Discussion Document extract	Issue
	only the untaxed income would be subject to the CFC regime.	
7.29	There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand's right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.	What sense are we allocating income to a non-resident settlor? For example, if a foreign Trust has NZ sourced income, it is subject to NZ tax, there is no allocation to any settlor? How is a foreign trust a reverse hybrid when it gets a legislative tax exemption on foreign source income? When would the settlor be in the same control group as the Trust? What if the Trustee does not know how each beneficiary is taxed in each foreign jurisdiction where beneficiaries reside? What if beneficiaries do not reside in any country? What is the income? Is it dividend income, FIF income, or CFC income? For example, where foreign trust has FIF and CFC interests and the non-resident beneficiaries are only taxed on dividend income? What if the countries of the beneficiaries do not tax foreign sourced income? Why are these proposals overriding existing tax structures without consultation on why this is occurring? (Foreign Trusts and foreign PIEs)
7.30	The definition of a "control group" is discussed in more detail in Chapter 12. The definition is designed to apply to partnerships and trusts as well as to corporate groups. Example 11.1 of the Final Report demonstrates that:	Appointment of trustee gives rise to what percentage of voting interests? What else makes up voting interest in a foreign trust?

Para	Discussion Document extract	Issue
	• the power to appoint a trustee of a trust is treated as a voting interest in the trust; • where a settlor's immediate family are the beneficiaries of a trust, they will be treated as holding equity interests in the trust, and these equity interests will be deemed held by the settlor under the "acting together" test.	Family members will be deemed as holding equity interest in the trust. What does this mean? What percentage is this compared to all possible beneficiaries? What happens if there are multiple settlers, settlers who are deceased or do not exist? What are immediate family members?
8.6	The primary response means that in most cases a New Zealand resident will not be able to claim an immediate deduction for a foreign branch loss except against income from the same country. This is because in most cases it will be possible for those losses to be used to offset non dual-inclusion income in the branch country. Unless it can be shown that such an offset is not possible, those losses will have to be carried forward and used either: • to offset net income from the branch in future years; • without restriction, if the losses have become unusable in the branch country, for instance because the branch has been closed down before the losses have been used or because of an ownership change. In this case the losses are referred to as "stranded losses".	Why most cases? In most cases of a foreign branch, the only activity in that jurisdiction will be the foreign branch, i.e. there will be no other activity. Where there is only a single foreign branch operation, what is the other dual-inclusion income in the branch country? What is the definition of a branch?
Submission point 8	Submissions are sought on whether the denial of a deduction for foreign branch losses against New Zealand income should be matched by an exemption for active income earned through a	What is proposed in relation to the possible branch exemption? When would it apply from?

Para	Discussion Document extract	Issue
	foreign branch. This would put foreign branches of New Zealand companies in a similar New Zealand tax position to foreign subsidiaries.	What realizations would occur on moving from existing branch tax to exemption regime? Would trading stock gains, depreciation recoveries etc. be realized? What will be included as a branch? Will the existing active/passive rules apply to the branch? What is the FX treatment of investment into the branch?
10.7		
10.10	As it is part of the OECD recommendations, it is proposed that New Zealand should introduce an imported hybrid rule. Multinational groups with Australian or UK members will already need to be keeping track of uncorrected hybrid mismatches for the purpose of compliance with the rules in those countries, so the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context.	Presumably Officials agree there are significant compliance costs for groups outside UK and Australian ownership? How is the IRD going to audit this?
11.4	In accordance with the OECD recommendations, we propose that denial of a deduction for a payment under any of the hybrid rules would not affect its withholding tax treatment.	Can you confirm the resulting tax payable would be treated as imputation credits for a company eligible to maintain an ICA? Will deductible payments be able to be fully imputed? If not, why not and how does the added layer of tax (28% plus additional withholding) be justified?
12.12-14	An investment in an entity can be a voting interest or an equity interest or both. A voting interest can	What is the proposed standalone definition?

Para	Discussion Document extract	Issue
	apply to non-corporate as well as corporate entities, and is a right to participate in decision making concerning distributions, changes in the person's constitution or the appointment of a director, broadly defined so that includes the persons who have management and control of an entity. A look-through test applies to trace interests through interposed entities. This approach is similar to that taken to determining whether or not two companies, two natural persons, and a company and a person other than a company, are associated under subpart YB 2 to YB 4 and YB 13 and YB 14, subject to the fact that for two companies, the test generally requires a 50 percent common ownership. However, the application to trusts and partnerships seems somewhat different. While it would make sense to build so far as possible on existing definitions, it is likely to be preferable to do so by using a stand-alone definition which combines existing concepts plus the modifications necessary to ensure that New Zealand's hybrid regime has the same scope as others enacted in accordance with Action 2.	What existing concepts will be used? How do you apply voting measurements to a discretionary structure where distributions and membership (i.e. beneficiaries) are totally discretionary?

#011

11 November 2016

c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Policy.webmaster@ird.govt.nz

Dear Deputy Commissioner,

Submission on the discussion document "Addressing hybrid mismatch arrangements"

Thank you for the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on the Government Discussion Document on Addressing Hybrid Mismatch Arrangements (the **Discussion Document**).

As an opening comment ANZ Bank New Zealand Limited (**ANZ**) supports the work being undertaken by the OECD to address real concerns over base erosion and profit shifting (**BEPS**). However, any measures implemented by New Zealand to address these concerns need to be co-ordinated at a multilateral level to ensure that New Zealand corporates are not placed at a competitive disadvantage.

In the context of anti-hybrid rules potentially to be adopted by New Zealand, ANZ considers that they should meet the following the broad principles:

i) be certain, clear and simple in scope and effect;
ii) not lead to impractical or excessive compliance requirements or unintended consequences;
iii) implementation should be consistent with New Zealand's major trading partners (particularly Australia) to ensure no adverse tax consequences for New Zealand's competitiveness;
iv) recognise the need for Reserve Bank of New Zealand (**RBNZ**) regulated financial institutions, including banks, to issue hybrid capital to manage prudential requirements; and
v) be sufficiently flexible to accommodate the frequent changes in the regulatory environment in which the banking system operates.

Summary of key submission points

ANZ's submissions centre on the possible impacts from the anti-hybrid proposals on bank regulatory capital and ANZ's branch arrangements. Our submissions are summarised below and we provide further context to our submissions in Appendix 1. We also summarise in Appendix 2 key bank regulatory capital obligations. ANZ considers it important that the purpose of these regulations is borne in mind in light of the potential disruption the anti-hybrid mismatch proposals may have on banks' regulatory capital.

1. ANZ submits that bank regulatory capital should be grand-parented from the anti-hybrid mismatch proposals for any bank regulatory capital issued prior to the date of enactment of any proposals or, at the earliest, prior to the date of release of the Discussion Document.

2. Any proposal to apply anti-hybrid mismatch rules to bank regulatory capital should be aligned, both in design and implementation dates (if the submission above is not accepted), to any proposals Australia may implement on bank regulatory capital. Aligning with Australia will assist in mitigating what could otherwise be excessive disruption (and possibly cost) to holders of impacted bank regulatory capital (which predominantly are retail holders), banks (in respect of ensuring compliance with prudential regulations) and prudential regulators.

3. ANZ is concerned that the second limb of the proposed definition of "structured arrangement" could capture all banking regulatory capital (other than common equity tier 1 capital) given the equity component in such instruments that arises from complying with the RBNZ framework. Such an outcome has the potential to impose excessive compliance costs upon banks. ANZ submits that the second limb of the definition of "structured arrangement" requires more detailed clarification to mitigate this risk.

4. Further consultation should occur before any legislation is drafted on the proposals. Also, any draft legislation should be made available to interested parties for comment prior to introduction of a Bill into Parliament. The proposals are complex and so will be any legislation on the proposals. To ensure any legislation from the proposals is certain, clear and simple with minimal compliance burden and minimal impact to underlying bank prudential regulation, a high degree of ongoing consultation will be required.

5. ANZ is concerned that the proposals may impact existing bank branch structures in respect of the underlying nature of how they are taxed, which, if this was the case, we consider would be an inadvertent outcome. It is uncertain from the Discussion Document whether or not this is the case. ANZ recommends further consultation occur to specifically address whether the existing bank branch structures are intended to be captured by any anti-hybrid proposals.

About ANZ

ANZ is the largest financial institution in New Zealand and is subject to the RBNZ's prudential supervision. The ANZ group comprises brands such as ANZ, UDC Finance, ANZ Investments, ANZ New Zealand Securities and Bonus Bonds.

ANZ offers a full range of financial products and services including a significant range of financial advisory services, personal banking, institutional banking and wealth management services.

Publication of submission

ANZ requests that this submission on the Discussion Document is kept confidential by the IRD on the grounds of commercial sensitivity.

Contact for submission

ANZ welcomes the opportunity to discuss any of our submissions directly with IRD officials. Please contact me on 9(2)(a) [redacted] if you would like to discuss our submission further.

Once again, we thank the IRD for the opportunity to have input into the proposals on addressing hybrid mismatch arrangements and look forward to ongoing consultation on this topic.

Yours sincerely

Philip Leath
GM Tax, New Zealand
ANZ Bank New Zealand Limited

APPENDIX 1 - Submission points

As the IRD are aware, Australia and New Zealand Banking Group Limited (**ANZBGL**), the Australian parent bank, has issued an Additional Tier 1 regulatory capital instrument primarily to the Australian retail market via its branch operations in New Zealand. This capital represents level 1 Additional Tier 1 regulatory capital for ANZBGL (i.e. as a standalone Approved Deposit Taking Institution) and is regulated by the Australian prudential regulator (**APRA**). The RBNZ framework requires regulatory capital issued by a special purpose vehicle to, in essence, be mirrored with regulatory capital issued by the New Zealand regulated bank. As such, ANZ has issued regulatory capital (on similar terms as the Additional Tier 1 issued by the New Zealand branch of ANZBGL) to the New Zealand branch of ANZBGL. This capital represents Additional Tier 1 regulatory capital for ANZ and is regulated by RBNZ. Both issuances of this capital are regulated by multiple other regulators, including rulings from both the Australian Tax Office and IRD.

1. Bank regulatory capital should be grand-parented from the anti-hybrid mismatch proposals for any bank regulatory capital issued prior to the date of enactment of any proposals or, at the earliest, prior to the date of release of the Discussion Document.

1.1 Paragraph 11.20 of the Discussion Document proposes a general rule for introduction of the proposal, being:

> *"The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311).* ***Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be.*** *Furthermore, the result achieved by the rules should not generally be a punitive one, rather it involves the loss of an unintended tax benefit. The Final Report also suggests that the rules should generally take effect from the beginning of a taxpayer's accounting period."*
>
> [Emphasis added]

1.2 ANZ considers that the principle for determining implementation timeframes should be to limit market and regulatory disruption, which would occur if there was a requirement for bank regulatory capital to be refinanced.

1.3 In light of this principle, ANZ recommends a more cautious approach be applied to bank regulatory capital than simply applying the general rule above. Given the idiosyncratic nature and systemic importance to the New Zealand banking system of bank regulatory capital (including the "frankable/ deductible" bank regulatory capital), ANZ submits a grand-parenting should exist from the anti-hybrid mismatch proposals for any bank regulatory capital issued prior to the date of enactment of the amending legislation or, at the earliest, prior to release of the Discussion Document. There has been no tangible certainty of New Zealand's response to the OECD's recommendations on hybrid instruments until the Discussion Document was released and, arguably, uncertainty still remains. This is particularly so in light of the Australian Board of Taxation still deliberating on this very topic.

1.4 The so called "frankable/ deductible" bank regulatory capital, as referred to in the Discussion Document, are issued to retail holders and not related parties. This very point is acknowledged by the Discussion Document at paragraph 2.14, but appears to have been omitted from paragraph 11.20, as above. It will be critical that this public retail market remains available to banks. As such, ANZ considers it preferable that existing issuances are grand-parented to minimise market (i.e. investor) disruption.

1.5 ANZ also notes that, generally, bank regulatory capital must be replaced with equivalent or higher ranked bank regulatory capital (refer BS16). It may not be possible to "restructure existing [bank regulatory capital] arrangements to avoid any adverse consequences" as is suggested in paragraph 11.20 of the Discussion Document. This is due to a combination of both:

a) The inherent hybrid nature of bank regulatory capital, which arises from the relevant conversion requirements of the regulations which gives such instruments an equity component; and
b) That it may be undesirable, commercially, to call the instruments. This undesirability arises from both a reputation risk (in that banks need access to multiple markets to issue regulatory capital) and, if many banks call some of their regulatory capital instruments in a similar timeframe as a result of the proposals, significant liquidity and pricing issues will arise from any replacement of the regulatory capital.

1.6 In the absence of grand-parenting, any restructure of existing instruments would require approvals from multiple regulators. Such regulators include APRA and RBNZ, as well as relevant tax authorities amongst others. Such approvals would require significant lead-in time and, ANZ considers, could not commence until, potentially, the enabling legislation is enacted or at least substantively certain of enactment (for example, it may be necessary to obtain relevant tax rulings on any restructure, which could not commence until the enabling legislation was enacted).

2. Any proposal to apply anti-hybrid mismatch rules to bank regulatory capital should be aligned, both in design and implementation dates (if the submission above is not accepted), to any proposals Australia may implement on bank regulatory capital.

2.1 The OECD's proposed hybrid mismatch rules focus on alignment between different countries' tax treatments in respect of hybrid arrangements. The effect of the proposed linking rules is that the tax treatment in New Zealand will materially depend on the tax treatment in other relevant countries, particularly Australia in the case of the frankable/ deductible bank regulatory capital.

2.2 However, the position Australia will take on bank regulatory capital remains uncertain. The Australian Board of Taxation has been tasked with undertaking a further review of the impact of anti-hybrid mismatch proposals on bank regulatory capital and, as at the date of this submission, is still due to report back to the Australian Treasurer on this topic.

2.3 Harmonising anti-hybrid mismatch proposals between Australia and New Zealand for bank regulatory capital will minimise market and regulatory disruptions from any restructuring of such bank regulatory capital to prudential regulators on both sides of the Tasman, investors, banks and other relevant regulators. More specifically, harmonisation will provide greater certainty on how and when to restructure (including redeeming) any existing bank regulatory capital than would be the case if harmonisation did not occur. To put this position more colloquially, to restructure only once in an integrated and trans-Tasman co-ordinated fashion makes more sense than presenting a possible risk of having to do so twice and also aligns with the OECD multilateral focus.

2.4 Further, we understand the Australian Board of Taxation is reviewing whether distributions paid on Additional Tier 1 capital should be treated as deductible distributions (as opposed to the current position which treats Additional Tier 1 as non-share equity). Such an approach would align the tax treatment of Additional Tier 1 capital with the prudential classification, be consistent in tax treatment with many of the G20 countries on Additional Tier 1 capital, de-risk the Australian financial system by opening access to new markets (i.e. increasing liquidity) and remove the current tax hybrid outcomes between Australia and New Zealand. If this were to be the case, it may become appropriate for New Zealand to exclude bank regulatory capital from the anti-hybrid mismatch proposals.

3. ANZ submits that the second limb of the definition of "structured arrangement" requires more detailed clarification to mitigate the risk that all banking regulatory capital (other than common equity tier 1 capital) is treated as a "structured arrangement".

3.1 Chapter 4 of the Discussion Document proposes that, in respect of financial instruments, the anti-hybrid mismatch rules apply to payments between related parties or under "structured arrangements". The proposed definition of "structured arrangements" is very broad and highly subjective, being one where either:

> *"the hybrid mismatch is priced into the terms of the arrangement; or*
>
> *the arrangement has a purpose or effect of producing a hybrid mismatch."*

3.2 ANZ is concerned that all Additional Tier 1 and Tier 2 bank regulatory capital could be captured by the second limb of this very broad and subjective definition. This is because such bank regulatory capital must contain a loss absorbency trigger, via either an unequivocal conversion into ordinary shares of the New Zealand registered bank (or Parent) or an unequivocal write-off. Due to the "regulatory haircut" that arises from write-off, it is highly preferable that a conversion occurs for bank regulatory capital. It is this very conversion feature (a requirement of bank prudential regulations) that can create a hybrid instrument. Uncertainty, therefore, exists as to whether Additional Tier 1 or Tier 2 bank regulatory capital would be classified as a "structured arrangement".

3.3 Uncertainty of tax outcomes is extremely unhelpful when raising bank regulatory capital. The tax outcomes of bank regulatory capital need to be certain prior to issuance in order to obtain the necessary non-objection notices from APRA and RBNZ issuances to be classified as bank regulatory capital.

3.4 ANZ submits that any legislation in respect of the proposals specifically exclude bank regulatory capital from the second limb of the "structured arrangement" definition. Another, more narrow approach, may be to exclude the relevant conversion scenarios (including loss absorbency, mandatory conversions and optional conversions) as imposed by bank prudential regulations from being *"an arrangement [that] has a purpose or effect of producing a hybrid mismatch"*. ANZ strongly recommends such exclusion is incorporated into legislation (rather than, say, guidance) to provide utmost certainty, which is highly important when raising bank regulatory capital.

4. Further consultation should occur before any legislation is drafted and any draft legislation should also be made available to interested parties for comment prior to introduction of a Bill into Parliament.

4.1 The Discussion Document (at paragraph 4.10) suggests that the hybrid mismatch rules may be contained in a separate subpart in the Income Tax Act 2007. Given the nature of BEPS and hybrid arrangements, we expect that the legislation will be very complex.

4.2 ANZ submits that, given this complexity, it will be critical that further detailed consultation on the proposals occur prior to any drafting of legislation. Further, ANZ submits that any draft legislation is circulated to interested parties for review prior to the relevant tax bill being introduced into Parliament.

4.3 Reviewing the legislation at the select committee stage would be insufficient for such complicated tax reform for interested parties, the IRD and Parliamentarians. It is also critical that a "right first time" approach is adopted, particularly given the terms and conditions of various financial instruments (including bank regulatory capital issued to the public) are likely to be required to reflect the very precise terms of any legislation.

5. ANZ recommends further consultation occur to specifically address whether the existing bank branch structures are intended to be captured by any anti-hybrid proposals.

5.1 As highlighted above, the proposals in the Discussion Document are highly complex. Further, ANZ considers their application to be uncertain in respect to whether or not some of the proposals may impact existing bank branch structures.

5.2 ANZ notes that its existing branch structures (both onshore and offshore branches) are subject to the well-established permanent establishment attribution rules within New Zealand's double tax agreements. In summary, these rules result in the country in which the permanent establishment (or branch) exists to have the primary taxing rights with the country of the Head Office having the secondary taxing right. ANZ considers such an outcome to reflect the economic arrangements and, as no non-inclusion/ deductible, double deduction or indirect deduction/ no inclusion outcome arises, is sufficiently disconnected from the BEPS concerns of the OECD.

5.3 However, as noted above, due to the complexity and uncertainty of the proposals, it is highly difficult to determine whether the proposals may adversely impact existing bank branch structures. ANZ recommends the IRD undertake explicit consultation if it intends that the proposals will impact existing bank branch structures, particularly in light of the initial "surprise" that occurred when the NRWT proposals were initially announced and the systemic importance of such branch structures to the New Zealand banking system.

APPENDIX 2 - Bank regulatory capital

The summary below focuses on the high level requirements of the minimum capital that New Zealand registered banks are required to maintain. These requirements are designed to enhance the security of the New Zealand banking system against, amongst other things, systemic risk of the economy. ANZ considers it important that the purpose of these bank capital regulations is borne in mind in light of the potential disruption the anti-hybrid mismatch proposals may have on these requirements and associated regulatory obligations.

The RBNZ introduced the common framework for determining the appropriate level of bank regulatory capital as set by the Basel Committee (referred to as the Basel III framework) from January 2013. This framework requires New Zealand incorporated banks to comply with minimum capital ratios, as calculated by the amount of capital that must be held in relation to risk-weighted exposures (including market and operation risk).

In addition, since January 2014, a bank that does not maintain a common equity buffer ratio of 2.5% above the minimum levels faces restrictions on distributions it can make. This part of the buffer represents the "conservation buffer", that is part of the Basel III framework.

The size of this required buffer ratio may be increased by the RBNZ to take account of macroeconomic risks that pose a risk to the New Zealand financial system (which represents the "counter-cyclical buffer", that is also part of the Basel III framework). At present, the combined minimum capital ratios are:

Minimum Capital Ratios	**Common Equity Tier 1**	**Total Tier 1 Capital**	**Total Capital**
Basel III Minimum Capital Ratio	4.5%	6.0%	8.0%
Conservation Buffer	2.5%	2.5%	2.5%
Total Capital ratio	7.0%	8.5%	10.5%

Very broadly, bank capital refers to the funding of a bank that is available to absorb financial losses that the bank may suffer, without depositors and general creditors necessarily suffering losses. It includes the accounting equity of the bank group and also certain qualifying instruments.

ANZ is accredited to apply the RBNZ's "Capital Adequacy Framework (Internal Models Based Approach)" (**BS2B**) to calculate its capital ratio requirements. The key requirements of the capital to be applied in calculating the minimum capital ratio levels can be summarised in the following table.

Key requirements	Common Equity Tier 1	Additional tier 1 capital	Tier 2 Capital
Subordination	Most subordinated claim in liquidation of bank	Subordinated to depositors, general creditors and other subordinated debt of bank	Subordinated to depositors and general creditors
Permanence	Principal is perpetual with no set redemption date	Principal is perpetual but instrument may be redeemable after five years or when a tax or regulatory event occurs (redemption requires regulator consent)	Initial term must be at least five years, but may be redeemable after five years or when a tax or regulatory event occurs (redemption requires regulator consent)
Flexibility of payment	Distributions are non-obligatory and non-cumulative	Distributions are non-obligatory and non-cumulative	Distributions are deferrable but may be cumulative
Loss Absorbency	Absorbs losses on a going concern basis	Principal loss absorption if the CET1 ratio of the banking group falls below 5.125% (if classified as a liability) and on occurrence of non-viability trigger event	Principal loss absorption on occurrence of non-viability trigger event

Common Equity Tier 1 capital comprises ordinary shares, retained earnings and reserves less certain deductions, as stipulated by BS2B.

Additional Tier 1 capital loss absorbency requires the instrument to either irrevocably convert into ordinary shares of the registered bank (or parent entity of the registered bank) or irrevocably be written off on a capital trigger event or on occurrence of a non-viability trigger event (refer Subparts 2E and 2F of BS2B). Similarly, Tier 2 capital must also be capable of conversion into ordinary shares of the registered bank (or parent bank) or written off, but only on occurrence of a non-viability trigger event (refer Subpart 2F of BS2B).

The tax consequences on conversion of a regulatory capital instrument are important because of the so-called "regulatory haircut" that arises with respect to regulatory capital recognition under the RBNZ Framework. More specifically, BS2B stipulates that:

> *"In determining the value of an instrument for the purposes of regulatory capital recognition, the face value of an instrument must be reduced by any potential tax or other offsets that may reduce the amount of Common Equity Tier 1 capital generated for the registered bank as the result of conversion or write-off. Adjustments must be updated over time to reflect the best estimate of the potential tax and offset value. Potential tax liabilities should be based on the contractually intended mechanism, rather than the potential write-off ..."*

It is for this reason that a conversion scenario is highly preferable to a write-off scenario. Given the tax complexity of a debt instrument that also contain an equity element (via the conversion requirement) and the importance to banks of recognising the full regulatory value of a regulatory capital instrument (i.e. not incurring the regulatory haircut), binding rulings are obtained to confirm tax treatments. Binding rulings are also a requirement of the RBNZ (refer "Application Requirements for Capital Recognition or Repayment and Notification Requirements in Respect of Capital" (**BS16**) – paragraph 18 and 19).

In order to qualify as regulatory capital, a registered bank must first obtain a non-objection notice from the RBNZ. Further, a bank cannot redeem/ repay bank regulatory capital unless it has received prior written approval from the RBNZ. This approval includes that:

> *"... prior to or concurrent with the repayment, the instrument is replaced with a paid-up capital instrument of the same or better quality and the terms and conditions of the replacement instrument are sustainable for the income capacity of the banking group. However, a replacement instrument is not required where the bank can demonstrate to the Reserve Bank's satisfaction that the banking group's capital position would be sufficiently above the minimum capital requirements after the repayment."* (refer paragraph 22 of BS16 and BS2B).

#012

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A member of the
Commonwealth Bank
of Australia Group

11 November 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner
Policy and Strategy
Inland Revenue Department
PO Box 2198
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Via email: policy.webmaster@ird.govt.nz

SUBMISSION ON THE ADDRESSING HYBRID MISMATCH ARRANGEMENTS GOVERNMENT DISCUSSION DOCUMENT

ASB Bank Limited (ASB) is writing to submit on the *"Addressing Hybrid Mismatch Arrangements Government Discussion Document"* (the discussion document).

ASB appreciates having the opportunity to provide feedback to the Inland Revenue Department ("IRD") on the discussion document. We are happy to engage further with IRD officials to discuss our feedback.

As an introductory comment, we support the general direction of the OECD in tackling various global tax concerns through the base erosion and profit shifting ("BEPS") initiatives. However, we do recommend caution in the pace and format in which New Zealand adopts these BEPS initiatives. In the case of the hybrid mismatch proposals which are the subject of the discussion document, the proposals are extremely complex. This complexity will be increased further in situations where New Zealand has adopted these rules and key trading partners have not, and in situations where the application of our rules differs materially from regimes adopted overseas.

Our following comments address the potential impact that the discussion document proposals will have on bank regulatory capital.

1. Submission Point 5H

There are a number of issues with providing no exclusion for bank regulatory capital. We believe that bank regulatory capital instruments should be removed from the scope of the hybrid mismatch proposals.

In the Australasian banking sector, this is critical because a number of the New Zealand major banks are owned by the Australian major banks. Under both the regulatory capital rules imposed by the Australian Prudential Regulation Authority ("APRA") and

those of the Reserve Bank of New Zealand ("RBNZ"), regulatory capital instruments issued by a New Zealand branch or subsidiary may have dual recognition in both jurisdictions (ie, recognition as capital for the New Zealand branch or subsidiary as regulated by the RBNZ, as well as recognition as capital for the consolidated banking group regulated by APRA). Similarly, under the tax rules in Australia and New Zealand, they may have tax consequences in both jurisdictions.

As an example of the kinds of bank regulatory capital issues that may be affected, Additional Tier 1 Capital ("AT1") instruments issued by a New Zealand branch of an Australian parent bank are more likely to result in cross border mismatches, due to the interaction of the banking regulators' requirements for the form of AT1 capital and the application of Australia's debt equity classification rules for tax purposes. The hybrid form of these instruments is driven by regulatory capital requirements, designed to help absorb the impact of any banking stresses and thereby protect depositors. The tax mismatch outcomes are essentially a result of Australia's complex tax rules. Unless certain very restrictive criteria can be satisfied under Australian tax rules, a New Zealand branch of an Australian bank, issuing AT1 capital, has no choice but to attach franking credits to payments made under these instruments.

In our view, regulatory capital falls into a very different category of transaction to financial instruments designed to produce a certain tax outcome, for reasons that include the following:

1. The terms of the instruments are driven by regulatory requirements and not tax avoidance; this has been confirmed in both the Australian High Court in *Mills v Commissioner of Taxation* and through a number of binding rulings issued by the Inland Revenue Department in respect of these transactions.
2. The instruments are also raising funds for deployment in New Zealand
3. The instruments are publicly issued, and are not related party or structured arrangements designed to produce a certain tax outcome.

In relation to the New Zealand tax impact of AT1 instruments issued by a New Zealand branch of an Australian bank which are frankable, it is important to note that, as a commercial matter, the New Zealand branch then negotiates with investors to ensure that the value of the franking credits in the investors' hands is recognised. This prevents the New Zealand branch from "over-compensating" the investors. Specifically, the terms of the instruments provide that the return can be paid wholly in cash or partly in franking credits. Where a return is paid in franking credits, this reduces the cash payment and therefore the deduction claimed in New Zealand. Eliminating the ability to pay the coupons partly in franking credits will increase the cash payments and hence the interest deductions in New Zealand. Australian investors themselves are indifferent to the receipt of franking credits or cash as this generally does not impact their after tax return.

Franking credits represent actual tax paid in Australia and are available to the company to attach to shareholder distributions; there is no requirement in Australia, or under New Zealand's equivalent imputation regime, to attach credits only to cash derived from transactions that were themselves subject to tax. For example, an amount derived as a

non-taxable capital transaction can be paid out to New Zealand shareholders as an imputed dividend. The rules operate on a pooled basis rather than requiring tracing.

Disallowing these credits, or denying a deduction in New Zealand for franked distributions, runs counter to these pooling principles.

Specific submissions:

1. We question whether it is in New Zealand's best interests to introduce rules impacting bank regulatory capital that may increase interest deductions claimed in New Zealand.
2. The pool of funding available in New Zealand to fund the AT1 requirements of New Zealand banks is limited. Placing impediments on the ability of New Zealand banks to raise capital overseas will likely increase the overall cost of capital in New Zealand and will come at the expense of higher borrowing costs for New Zealand customers.
3. The terms of these instruments are driven by regulatory capital requirements; and the obligation to attach franking credits is driven by Australian tax requirements. Regulatory capital requirements only apply to a narrow range of entities. We consider that these transactions do not pose the same concerns to tax bases as other more tax driven transactions and should be removed from the scope of the hybrid proposals.
4. Franking credits represent actual tax paid in Australia. Where franking credits are attached to hybrid distributions, this reduces the franking credits available to attach to other distributions and therefore gives rise to a real economic cost. The IRD discussion document acknowledges but discounts this; we consider this aspect is not given sufficient weight. The Australian banks generally have significantly high dividend payout ratios, therefore any so called timing advantage is likely to be short lived.
5. Other jurisdictions around the world have been actively looking at carving out regulatory capital from the implementation of anti-hybrid rules because the rules run contrary to other national policies which are aimed at increasing the capital strength of the banking system and therefore the strength of their economies.

2. Submission point 11E

We consider it essential that in the event the hybrid mismatch proposals enacted do not carve out bank regulatory capital instruments, there should be a grandparenting period in respect of existing bank regulatory instruments on issue.

Paragraph 11.20 of the discussion document suggests that the hybrid rules should apply to all payments made after the effective date of the new rules, on the basis that this date is sufficiently far away that taxpayers will have time to restructure existing arrangements to avoid adverse consequences. However, the deductible frankable AT1

instruments issued in NZ (totalling in excess of NZD5bn) are invariably long dated and often involve unrelated investors with no knowledge of any so called unintended tax benefits in how these instruments are taxed. On the contrary, these instruments are generally supported by binding rulings in Australia and New Zealand confirming the tax treatment in those jurisdictions. There is no commercial ability to restructure these instruments to avoid the application of the hybrid rules and the life of the instruments generally extends beyond the likely effective date of any hybrids mismatch legislation in New Zealand. Therefore, the rationale for not grandparenting does not apply to the AT1 instruments already issued.

As noted above, other jurisdictions around the world have been actively looking at carving out regulatory capital from the implementation of anti-hybrid rules. Even following the issue of the OECD Final Report on Neutralising the Effects of Hybrids Mismatch Arrangements ("the OECD Final Report"), in late 2015, there has been no certainty that regulatory capital would be included in the scope of any hybrid mismatch rules implemented in New Zealand and Australia. The IRD had not made any public announcements of the exact scope of any intended changes prior to the release of the discussion document. We believe grandparenting should apply to all instruments on issue prior to the release of the IRD discussion document.

If the AT1 cross border instruments are not grandparented, there is a high likelihood that many of these instruments would need to be terminated and refinanced. The market reality is that if there are a large number of refinancing instruments going into the market at more or less the same time, the funding is likely to be expensive where available, and difficult to source. This would place strain on the banking sector, impacting funding costs and potentially the ability to write new business or meet existing funding ratio requirements. The effective recall of existing instruments on issue would also affect investor confidence in issues of this type, which is of significant concern given the importance of these instruments in achieving prudential banking requirements.

The AT1 instruments that are on issue in New Zealand will generally reach economic maturity within 5 years of any likely effective date. Lending decisions will have been made in reliance on this funding. It would be consistent with the approach taken in respect of the upcoming changes to onshore and offshore branch NRWT treatment, to allow existing instruments that are already on issue to be grandparented for a period of up to 5 years, to allow these instruments to mature without disrupting the market and the loan pricing decisions already made.

There are a number of reasons why New Zealand should seek to align with Australia on the timing of introduction of hybrid rules, the content of the rules and the timing and content of grandparenting provisions.

The nature of the hybrid proposals is that if Australia does apply Recommendation 2.1 of the OECD Final Report, but grandparents the existing deductible frankable AT1 instruments for a period and New Zealand does not, the primary rule would then apply to disallow the deduction in New Zealand. This would frustrate the intent of the Australian grandparenting and likely result in the need to terminate existing issues, which is very undesirable for the reasons discussed above.

If New Zealand is not at least aligned with Australia on the timing of introduction of hybrid rules, then New Zealand taxpayers will face significant compliance costs having to work through the varying implications that may arise over time due to that misalignment. This could give rise to several different tax treatments arising over the life of an instrument.

Specific Submissions:

1. Given the difficulty and complexity of unwinding AT1 instruments, existing AT1 instruments on issue at the date that the IRD discussion document was released should be grandparented from the application of any anti-hybrid rules introduced in New Zealand.
2. Given the long lived nature of AT1 instruments, we submit that the grandparenting should apply for a period of at least 5 years from the date of application of any hybrid mismatch rules.
3. Wherever possible, New Zealand should strive to align content of the rules and application dates including grandparenting dates with Australia.

We also recommend that there is further detailed consultation on the content of any draft legislation before these proposals reach the stage of formally being introduced to Parliament in a Bill. The devil will very much be in the detail and it is critical that the legislation does not overreach and only captures the arrangements intended.

If you would like further details we would be happy to discuss the points raised in this submission. My contact details are 9(2)(a) [redacted] or adrian.michael@asb.co.nz.

Yours faithfully

Adrian Michael
General Manager, ASB Taxation

11 November 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir

Addressing Hybrid Mismatch Arrangements

Dear Sir

We refer to *Addressing hybrid mismatch arrangements: A Government discussion document* ("the Document"), which was released for consultation on 6 September 2016. We appreciate the opportunity to comment and do so below.

1. Insurance Australia Group Business

Insurance Australia Group Limited ("IAG") is an Australian resident company operating in Australia, New Zealand, and Asia. IAG is the leading general insurance provider in New Zealand across both the direct and intermediated channels. Insurance products are sold directly to customers predominantly under the State and AMI brands, and through intermediaries (insurance brokers and authorised representatives) predominantly under the Lumley and NZI brands.

2. Executive Summary

IAG supports the aims of the New Zealand government in addressing hybrid mismatches. Our submissions address aspects of the proposals which would negatively impact our New Zealand business model, rather than commenting on the entire package. We submit that:

- With regard to frankable/deductible structures in general, the New Zealand government should not deny an interest deduction. As such structures are not tax exempt in Australia, a hybrid mismatch is not generated
- Should our primary submission be declined, the government should exempt regulatory capital from the scope of any measures to address hybrid mismatches, given its commercial importance
- In the event that each of these submissions are declined, the government should grandparent existing instruments from the impact of the proposals, and
- Regardless of the government's views on the submissions above, any measures affecting taxation of insurance industry capital should be deferred given the current changeable regulatory and tax situation worldwide.

3. IAG's issue of Reset Exchangeable Securities

IAG's interests centre on the application of the proposals to regulatory capital for insurers. The New Zealand branch of IAG Finance (New Zealand) Limited, a wholly owned subsidiary of IAG, has issued perpetual reset exchangeable notes, known as

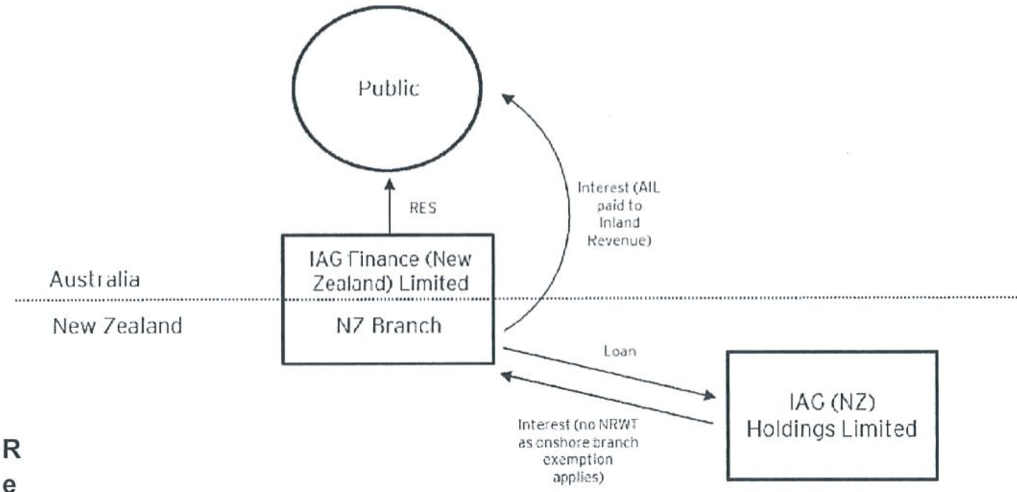
Reset Exchangeable Securities ("RES") to external investors. The $550 million funds raised have been loaned to IAG (NZ) Holdings Limited to fund IAG's New Zealand operations. The RES are used to raise funds and enhance IAG's capital structure by providing certainty of access to regulatory Tier 1 Capital if needed.

The RES may be exchanged by IAG or the holder on a reset date, or upon certain events. The next reset date is 16 December 2019. On exchange, IAG may convert RES into IAG preference shares, arrange a third party to acquire RES for their face value or redeem RES for their face value (subject to Australian Prudential Regulation Authority ["APRA"] approval).

The RES instrument, in its 2004 original form and its 2009 amended form, has been a key component of the IAG capital structure for 12 years. Since 2009, it has qualified as innovative Tier 1 capital and upper Tier 2 capital.

These arrangements are summarised in Figure 1.

Figure 1: IAG Finance (New Zealand) Limited existing funding arrangements



3.1. Relation to proposals in the document

At paragraph 2.14, the Document refers to *"frankable/deductible instruments issued by the New Zealand branch of some Australian banks to the Australian public"*. The RES broadly follows the tax treatment explained in that paragraph. Although issued to third parties and listed on the ASX, it appears likely that the RES would fall within the definition of "structured arrangement" summarised at paragraph 12.5, and therefore fall within the scope of the document's proposals.

The RES are regulatory capital, with IAG under the supervision of APRA. At paragraph 5.60, the document states that government does not propose to exclude regulatory capital from the implementation of hybrid mismatch rules.

4. Treatment of frankable/deductible instruments

We submit that New Zealand should not enact legislation to deny a deduction for amounts paid under deductible/frankable instruments such as the RES on the grounds that there is no hybrid mismatch against which action can be justified.

IAG does not agree with the assertion that *"there is no practical distinction between exemption and full imputation"*.[1] Amounts paid to RES investors are fully taxed in the investors' hands and in no way exempt. The franking credits attached represent

[1] See para 5.5, at page 32.

underlying Australian tax paid and are therefore no longer available to be attached to other profit distributions. The instrument does not produce a deduction no inclusion ("D/NI") result.

While we appreciate that that the Document's analysis of frankable/deductible instruments is consistent with that in the OECD's report[2], that analysis is flawed. As New Zealand and Australia are the only two closely integrated economies with imputation systems, there is no need here to seek to follow international norms: decisions taken by the New Zealand and Australian government regarding imputation will be the international norm.

5. Exempting hybrid regulatory capital from hybrid proposals

Submission point 5H specifically requests comments regarding regulatory capital. IAG submits that in the event of our primary submission regarding frankable/deductible structures being declined:

- A specific definition of insurance regulatory capital is introduced. That definition could be closely linked to the regulatory rules set by the parent company regulator, in this case, APRA, and
- Insurance regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

We wish to make several points in support of our submission.

5.1. Efficiency of commercial insurance operations

Stringent rules could negatively impact the efficiency of commercial insurance operations. This will be due to the increase in the cost of capital without the present deductions. It may make New Zealand a less attractive destination with negative implications for the availability and price of insurance coverage. As a net capital importer this should be a major concern for any New Zealand government.

5.2. Commercial use of branches within insurance sector

The document implicitly assumes that the use of branches has limited, if any, commercial rationale. However, for many commercial, regulatory and operational reasons, insurers commonly operate internationally through branches. Rather than dispersing regulatory capital around a series of local subsidiaries, a "hub and branch" structure allows groups to free up capital and use it more flexibly by holding and managing it centrally. This approach is particularly common within the European Union and branches also play a part in the New Zealand market. The higher capitalisation possible through a hub and branch structure can give greater risk protection. It also gives access to lighter handed regulation and greater flexibility in doing business.

5.3. Importance of regulatory hybrid capital within insurance sector

Unlike most other industry groups, insurers face regulatory requirements to hold loss-absorbent capital as a proportion of their balance sheet size and risk. These requirements increase insurers' ability to deal with periods of high claims and reduce harmful effects for the wider economy.

Regulatory hybrid capital instruments have been popular within the insurance industry for around 15 years. Hybrid securities are considered an attractive, cost-efficient means of raising funds without diluting shareholders' rights. Forming an integral part of the regulatory capital of insurers such as IAG, instruments such as

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[2]See Example 2.1 at page 280, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (OECD, October 2015)

the RES have certain equity-like features relating to loss absorbency and interest deferral which are mandated by regulators such as APRA. These equity-like features are mandated by regulation, are not designed to give a tax mismatch and are essential in supporting the insurance industry.

Following the global financial crisis, the degree of regulation has increased, with enhanced capital requirements and greater transparency. Regulators continue to see hybrid capital as having a valuable function, rather than attempting to close down the opportunity to issue such capital. Although the regulatory environment remains subject to reform, IAG is concerned that New Zealand tax officials are seeking to substitute their judgment of the merits of such capital to that of the regulator concerned.

5.4. Regulatory capital and BEPS

The Document does not explain how the payment of interest on regulatory capital enables BEPS. The purpose of regulatory capital is to reduce risks associated with leverage, rather than to increase it. In those circumstances, it appears counterintuitive to apply rules designed to counteract "excessive" leverage to regulatory capital.

Given this there is little risk of regulatory capital for insurers giving rise to BEPS issues and, accordingly, regulatory capital that conforms to the requirements of the particular regulator should be outside the scope of these proposals. The amount of capital that a particular entity requires is determined by the regulatory regime to which it is subject, the responsible regulator in IAG's case being APRA. The terms of regulatory capital securities that lead to hybridity are consistent with regulatory requirements. Likewise, there are restrictions on how much of IAG's minimum capital requirements can be made up of the different tiers of capital. The precise percentages applicable to IAG are the subject of discussion with APRA.

Regulatory oversight therefore provides an objective measure of how much additional Tier 1 and Tier 2 capital IAG may need. We note that the United Kingdom, which has consulted widely on issues associated with regulatory capital, has determined that anti-hybrid measures concerning regulatory capital are not required.

5.5. Tax outcomes for regulatory capital

IAG is concerned that even though structures, such as the RES mentioned above, were not implemented with tax avoidance in mind, the government's proposals would result in payments by the New Zealand branch of IAG Finance (New Zealand) Limited being denied tax deductions in New Zealand.

The denial of tax deductions or imposition of tax charges could lead to unfair results for IAG and other insurers. Our cost of capital would increase, making New Zealand a less attractive place for inbound insurance and reinsurance business. This outcome appears contrary to the overarching goal for New Zealand's tax system of maximising the welfare of New Zealanders, in part by ensuring that taxes from inbound investment are as fair and efficient as possible and that New Zealand remains an attractive place to invest and base a business, and by minimising distortions so that investments are financed in ways that are most efficient and undertaken by those who can do so most efficiently.[3] In particular, the Document lacks any analysis of whether the policy considerations behind requirements for better capitalised financial services institutions outweigh any perceived BEPS risk.

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[3]As set out in New Zealand's taxation framework for inbound investment: A draft overview of current tax policy settings (June 2016), pp 3-4.

While commercial in nature, the RES have been designed with an expectation that the interest payments made by IAG are tax deductible. A tax deduction is necessary for the RES to provide a lower after-tax cost of capital for IAG. In effect, switching off the tax deduction is likely to make the RES an inefficient form of capital and, over time, remove investment opportunities and weaken capital markets in Australasia.

5.6. Consideration in overseas jurisdictions

Many jurisdictions have made conscious policy decisions to ensure that deductions are available in respect of coupons paid on Additional Tier 1 and Tier 2 capital instruments. This is the case within the European Union, where the majority of Member States have put in place rules which provide for payments under these types of instruments to be deductible, and elsewhere. It is not obvious to IAG that there is a need to harmonise conscious tax policy choices that individual countries have made in relation to regulatory capital and the application of anti-hybrid recommendations in respect of that capital.

6. Effective date for introduction of new rules

Submission point 11E requests comments on whether there are any special circumstances that would warrant departing from the general proposition of no grandparenting.

IAG submits that, in the event that our preceding submissions regarding frankable/deductible structure and insurance regulatory capital are rejected; then existing arrangements, in particular the RES, should be fully grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting period should be the absolute minimum requirement.

6.1. Analysis in document does not consider structured arrangements

One of the crucial statements concerning the Document's discussion of effective date are inconsistent with IAG's circumstances. The Document assumes that the rules will "*generally apply to arrangements between related parties or within a control group*"[4], whereas the RES are issued to third parties and listed on the ASX. The RES will only be subject to the proposals because of the intended broad definition of structured arrangement.[5]

The Document goes on to state that the result should not generally be punitive, rather involving the loss of an unintended tax benefit. As we have submitted above, in IAG's case, the RES does not lead to a tax benefit or D/NI outcome.

Finally, the Document also states that the impact of the proposals will in most case be able to be established now, by reference to the OECD's Final Report. We consider that any assumption that OECD recommendations should be deemed to represent New Zealand law on complex, large, economically significant transactions, in advance of any government decisions on the matters in question to be an abuse of due process. Decision regarding New Zealand law should be made by Parliament, not asserted through discussion documents.

6.2. Inability to quickly unwind existing structure

The RES are a perpetual instrument held by third parties, with the next reset date not being until December 2019. Holders have chosen to invest based on current law and the RES have been costed on that basis. It would be prohibitively

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[4] See paragraph 11.20 to 11.22 at page 78.
[5] See paragraph 12.5 to 12.7 at pages 80-81.

expensive to seek to unwind the structure before that date as investors have a legitimate expectation of a particular return until that date.

If more targeted rules are not applied there should be a considerable grandparenting provision or a period during which restructuring of hybrids can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise. This is consistent with the proposed application of non-resident withholding tax or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill.[6] We also note that transitional arrangements proposed for measures in connection with employee share schemes will extend until 2022.[7] The financial impact of unwinding instruments such as the RES far outweighs that of changes to employee share schemes.

7. Changeable current regulatory and taxation environment for insurers

Finally, we submit that the current regulatory and taxation environment for insurers is sufficiently changeable that all New Zealand tax measures affecting the treatment of regulatory insurance capital should be deferred. We make this point regardless of the government's decisions on our points above.

7.1. Insurance prudential regulation is evolving

The insurance industry is subject to global economic factors such as weak economic growth, low inflation rates, volatile financial markets and near-zero interest rates.

Internationally, we are seeing unprecedented levels of interaction among various insurance regulators—with a strong push for global standards in a broad range of areas from capital requirements to risk management. The International Association of Insurance Supervisors (IAIS) is now developing the first-ever global capital standards for large insurance groups that are active in multiple jurisdictions. The International Capital Standard is intended to be a truly global group measure unlike any current regulatory practice.

While the development of global capital standards will be a significant hurdle, IAG suspects that there will be many changes for the insurance industry in the next few years. Standards are likely to continue to evolve, rather than face a single point of change. Capital standards will interact across jurisdictions and with other aspects of regulation, with unknown results. There will be change at both a local and global level.

In New Zealand, for example, the Reserve Bank is planning a review of the Insurance (Prudential Supervision) Act 2010 (IPSA).[8] IPSA provides the comprehensive framework for the prudential regulation and supervision of insurers

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[6] See clauses 5(4)(a), 5(4)(b) and 5(6) of the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill , which cover lending from a third party with a New Zealand branch, a foreign parent with a New Zealand branch and bank wholesale funding respectively. We consider these situations to be a much closer parallel to the RES than other parts of the non-resident withholding tax anti-deferral package referred to by the Document.

[7] See Tax treatment of employee share schemes – further consultation (September 2016), paragraph 38 at page 13.

[8] Terms of reference for the review can be viewed at http://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/insurers/regulation/Terms-of-reference.pdf?la=en

in New Zealand. The Reserve Bank plans to publish an issues paper in late 2016. We consider that it makes sense to assess any proposals to change IPSA before seeking to make tax changes affecting regulatory capital for the industry.

7.2. Tax treatment of insurance industry globally remains uncertain

The tax environment for insurers is currently, if anything, less certain than the regulatory requirements. In addition to the proposals in this Document, insurers may also be subject to restrictions on interest deductibility through BEPS Action 4. In this regard, the OECD has noted that *"Further work would be conducted in 2016 to identify appropriate approaches to address BEPS risks in these entities, taking into account the risks posed, the role interest plays in banking and insurance businesses, and restrictions already imposed by capital regulation. In particular it was noted that any approaches adopted should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis."*[9] Such work has not yet been completed, with the OECD currently considering public comments received regarding Action 4.

In IAG's view, it is important to examine all changes which will affect insurer's regulatory capital as a whole, rather than to separate reforms under BEPS Action 2 (as proposed in this Document) and pending reforms under BEPS Action 4.

IAG has yet to see other countries take action in isolation regarding regulatory hybrid capital. The Australian approach to date has been measured and represents an example which could be followed by New Zealand. The Australian Board of Taxation has reported that implementing changes to frankable/deductible hybrid regulatory capital structures *"would require a holistic review of Australia's tax treatment of regulatory capital, encompassing potential changes to section 215-10 and the franking streaming rules."*[10] The Board sought, and was granted, further time to consider:

- the complexities and interactions involved
- the limited time period in which this review was able to be undertaken, and
- the need to undertake a holistic review to assess and ensure unintended consequences do not arise.

We understand that the Board's report has been further delayed beyond its extended deadline of July 2016.

8. Conclusion

We would be keen to discuss the points raised in this submission in more detail. Please contact Craig Hespe [redacted]) in the first instance.

Yours faithfully

Craig Hespe
Head of Group Taxation

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[9] See BEPS Action 4 Approaches to address BEPS involving interest in the banking and insurance sectors (OECD, 28 July 2016) at page 5.
[10] See Implementation of the OECD Hybrid Mismatch Rules: A Report to the Treasurer (The Board of Taxation, March 2016) at page 9.

NEW ZEALAND BANKERS ASSOCIATION

#014

Submission

to the

Inland Revenue Department

on

Addressing Hybrid Mismatch Arrangements: A Government Discussion Document

11 November 2016

NEW ZEALAND BANKERS ASSOCIATION
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About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fifteen registered banks in New Zealand are members of NZBA:

- ANZ Bank New Zealand Limited
- ASB Bank Limited
- Bank of China (NZ) Limited
- Bank of New Zealand
- Bank of Tokyo-Mitsubishi, UFJ
- Citibank, N.A.
- The Co-operative Bank Limited
- Heartland Bank Limited
- The Hongkong and Shanghai Banking Corporation Limited
- JPMorgan Chase Bank, N.A.
- Kiwibank Limited
- Rabobank New Zealand Limited
- SBS Bank
- TSB Bank Limited
- Westpac New Zealand Limited.

Background

3. NZBA welcomes the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on "Addressing Hybrid Mismatch Arrangements: A Government Discussion Document" (**Discussion Document**).

4. NZBA welcomes the opportunity to discuss any of our feedback directly with IRD officials and, as outlined in our feedback, we recommend ongoing discussions with IRD Officials on this topic as the proposals develop. In this regard, please contact:

Philip Leath
Chair of NZBA Tax Working Group
GM, Tax – ANZ
04 436 6493 / 021 280 4717

General Comments

5. As a general comment, NZBA supports the ongoing work of the OECD to address valid concerns over base erosion and profit shifting (**BEPS**). As is highlighted by the OECD, implementation of the OECD's BEPS recommendations should be co-ordinated on a multilateral approach. In the case of the anti-hybrid mismatch proposals, it will be important that New Zealand and Australia are aligned. In addition, given the complexity of the anti-hybrid mismatch proposals, it will be critical that any rules are clear and certain, particularly from a bank regulatory capital perspective to ensure certainty for investors, banks and the New Zealand banking system (including prudential regulators).

Submissions

6. NZBA outlines below key submission points in respect of the potential outcomes from the anti-hybrid mismatch proposal on bank regulatory capital. Our submissions focus on some of the specific questions raised in the Discussion Document and also provides general comments.

   a. NZBA submits that there should be exclusion of bank regulatory capital from the anti-hybrid mismatch proposals (submission point 5H in the Discussion Document). RBNZ and APRA require Additional Tier 1 and Tier 2 capital to contain loss absorbency measures on the occurrence of certain stress events by either a conversion trigger into ordinary shares of the registered (or parent) bank or for the capital to be written off[1]. The purpose of the loss absorbency measures is to absorb or protect against the impact of bank stresses and protect depositors. It is these, and other, regulatory conversion requirements that create an equity, and therefore hybrid element for such bank regulatory capital. In the case of the so called “frankable/deductible” bank regulatory capital, it is the combination of this regulatory conversion requirement and the Australian tax debt/ equity classification that results in the distributions being considered equity in Australia, upon which franking credits must be attached due to the streaming requirements of the Australian tax rules. The fact that the franking credits are not generated from the investments of the funds raised by the issue should not be relevant. If it were relevant, the natural concomitant would be to allow streaming of franking credits or, in New Zealand’s case, imputation credits – however, this is contrary to long standing New Zealand tax policy.

   b. If our submission that there should be an exclusion for bank regulatory capital is not accepted, NZBA submits that existing bank regulatory capital issuances should be grand-parented (submission point 11E in the Discussion Document). We consider such grand-parenting should apply for all bank regulatory capital issued prior to the date of enactment of the enabling legislation or, at the earliest, from the date of release of the Discussion Document. We note that significant global uncertainty remains over whether bank regulatory capital should be excluded from anti-hybrid proposals. The OECD final report, “Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report”, drew no firm conclusion on bank regulatory capital and recommended each country adopt its own approach on this topic. Australia has not yet concluded how it will approach bank regulatory capital as part of their proposed anti-hybrid mismatch proposals, despite considering this topic for considerable time (and, as we submit below, New Zealand should harmonise its approach on bank regulatory capital to any approach Australia adopts). In further support of this submission, we note that:

      i. Any potentially impacted bank regulatory capital will require multiple regulators’ approvals to restructure (where any request for such approval would, most likely, not be possible until legislation is enacted or, at least, substantively certain). It will also be important to ensure market liquidity exists for possible restructures, particularly as the potentially impacted bank regulatory capital issuances are held by the public and not related parties (contrary to what appears to be the inference from paragraph 11.20 of the Discussion Document). As such, it is preferable that bank regulatory capital

[1] As a write-off of bank regulatory capital results in a reduction to the regulatory value of an instrument (due to the tax liability that arises upon a write-off), the write-off option is economically undesirable (refer paragraphs 2.47 and 2.60 of RNBZ’s Capital Adequacy Framework (Internal Models based Approach) – BS2B).

is grand-parented or, at least, a significant lead-in time is provided for any restructure of bank regulatory capital.

ii. It is not possible to restructure bank regulatory capital with a different instrument to “avoid any adverse consequences” from the anti-hybrid mismatch proposals (as paragraph 11.20 of the Discussion Document suggests). This is because banks are required to hold regulatory capital and it is the regulatory requirements that create the hybrid element.

iii. Further, given the limited liquidity of available investors for bank regulatory capital, it would be highly risky to seek to restructure the existing issuances to be held by, say, different investors (i.e. other than Australian investors). This would particularly be the case if all banks were required to restructure at similar times. Any such restructure may undermine the very purpose of the regulatory capital regime – to safeguard the New Zealand banking system.

c. If our submission on grand-parenting is not accepted, NZBA submits that any proposals to apply the anti-hybrid mismatch proposals to bank regulatory capital should align, in both design and implementation dates, to the final position Australia adopts on bank regulatory capital in respect of their anti-hybrid approach. Harmonising the New Zealand approach to that of Australia would align to the OECD’s recommendation of taking a co-ordinated multi-lateral approach and minimise any additional market and regulatory disruptions that could arise if a different approach or timeframe were implemented. Harmonisation would be particularly important if Australia excludes bank regulatory capital from their anti-hybrid mismatch proposals (for example if they amend their rules to treat distributions on Additional Tier 1 capital as deductible) to ensure consistency across the trans-Tasman banking industry and regulators.

d. NZBA recommends extensive consultation occurs on any further development of the anti-hybrid mismatch proposals, importantly before legislation is drafted, and that any draft legislation/ exposure draft is made available to interested parties for comment prior to introduction to Parliament as a Bill. This is particularly relevant for bank regulatory capital issued to the public which contains terms and conditions that are dependent upon the precise wording of tax legislation. We would be very happy to set up working group meetings with appropriate representatives from members of the NZBA in this regard.

RUSSELL McVEAGH

11 November 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

By email

Email: policy.webmaster@ird.govt.nz

SUBMISSION: ADDRESSING HYBRID MISMATCH ARRANGEMENTS - DISCUSSION DOCUMENT DATED SEPTEMBER 2016

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document *Addressing hybrid mismatch arrangements* ("**Discussion Document**"). The Discussion Document seeks comments on how New Zealand should implement proposals set out in the OECD report *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* ("**OECD Report**"). We would be happy to discuss these submissions with Inland Revenue and Treasury officials if required.

1.2 References to "Recommendations" in this letter are references to the recommendations as set out in the OECD Report.

1.3 In summary, our submissions are:

General comments

<u>Process and timing</u>

(a) The OECD recommendations are complex and cut across a number of existing domestic tax regimes and a broad range of transactions. It is critical that New Zealand does not rush any decision to implement the proposals.

(b) Given the interdependent nature of the proposals, New Zealand should wait until it is known how and when other countries (and in particular Australia) will adopt the recommendations.

(c) If New Zealand does decide to adopt some or all of the OECD recommendations, exposure draft legislation should be released for consultation prior to the introduction of legislation to Parliament.

Grandfathering and general exclusions

(d) There should be grandfathering for existing arrangements. The proposed effective date (the beginning of a taxpayer's first accounting period after enactment of legislation) does not provide sufficient time for taxpayers to determine the likely impact of the rules and restructure existing arrangements.

(e) There should be an exclusion for bank regulatory capital, given that banking regulations effectively require banks to issue hybrid instruments for regulatory purposes. If not, bank regulatory capital should be included in any grandfathering provisions (per submission (d) above).

Regulation-making power

(f) We support the proposal (at paragraphs 11.18 and 11.19 of the Discussion Document) to permit the use of regulations to expand upon the detail of certain recommendations.

Recommendation 1 (Financial instruments)

(g) Implementation of the proposals in the Discussion Document will further inhibit the ability of New Zealand taxpayers to enter into securities lending transactions. If implemented, the hybrid mismatch rules should be drafted with a view to not discouraging these transactions with third parties.

Recommendation 5.2 (Limiting the tax transparency for non-resident investors)

(h) Recommendation 5.2 does not (contrary to Inland Revenue's suggestion) require New Zealand to tax the foreign-sourced trustee income of a New Zealand foreign trust to the extent it is not taxed in any other country. The fact New Zealand does not tax such income reflects the fact the income does not have a New Zealand source. It is not the result of a hybrid mismatch of the type with which the OECD Report is concerned.

(i) Inland Revenue's other proposals in respect of Recommendation 5.2 would significantly cut across existing domestic tax regimes and the scope of any such changes will need to be clearly set out and analysed before any decision to adopt them is made.

Recommendation 6 (Deductible hybrid payments rule)

(j) The proposal to apply the deductible hybrid payments rule to foreign branches of New Zealand companies would have wide-reaching consequences for arrangements which would not normally be considered "hybrids". If introduced, they should be accompanied by an active income exemption as proposed.

Recommendation 7 (Dual resident payer rule)

(k) Dual resident taxpayers should be denied a deduction in one jurisdiction only. To deny a deduction in both jurisdictions is punitive. Inland Revenue's assertion that "dual residence status is in most cases deliberate rather than accidental" does not reflect reality.

Recommendation 10 (Definition of structured arrangement)

(l) The definition of "structured arrangement" as described in the Discussion Document is overly broad, and would suggest that any transaction that on its terms gave rise to a hybrid mismatch would be a "structured arrangement". Any definition of "structured arrangement" in New Zealand should be more targeted, and should more closely reflect the policy object of the OECD Report.

(m) Recommendation 10.3 provides for an express exclusion from the definition of "structured arrangement" for taxpayers and any member of the same control group that could not reasonably have been aware of the hybrid mismatch and did not share in the value of the tax benefit. This exclusion should be included in any definition of "structured arrangement" adopted by New Zealand.

2. GENERAL COMMENTS

Process and timing

2.1 The OECD recommendations are complex and cut across a number of existing domestic tax regimes and a broad range of transactions. The proposals are not limited to specific classes of hybrid transaction, but are proposed to extend (for example) to limit the tax transparency of New Zealand limited partnerships with foreign limited partners (Recommendation 5.2), or to deny deductions for losses incurred by a New Zealand company with a foreign branch (Recommendation 6). New Zealand should not rush the implementation of such changes.

2.2 The need for caution is exacerbated by the fact that the impact of the proposals on New Zealand is dependent on the way in which the proposals are adopted in other countries (particularly Australia). For example, whether New Zealand is required (under the primary rule in Recommendation 1) to deny a deduction for a payment that is treated as interest in New Zealand but as a dividend in Australia may depend on:

(a) whether Australia adopts the specific recommendation (in Recommendation 2) to deny the benefit of franking credits on dividends which are deductible in the payer jurisdiction; and

(b) whether the Australian rule is yet in force at the relevant time.

2.3 Given New Zealand's size, it is unlikely that other countries (including Australia) will change the manner or timing of *their* implementation of the OECD recommendations to reflect any decisions made by New Zealand. New Zealand accordingly should not be the "first mover", but should wait

until it is known with certainty how and when other countries will adopt the recommendations.

Exposure draft legislation (Submission Point 11D)

2.4 If and when New Zealand does decide to adopt some or all of the OECD recommendations, exposure draft legislation should be released for public consultation prior to the Bill being introduced to Parliament. This is critical to enabling meaningful analysis of how the proposals may apply in practice and whether any unintended consequences may arise.

2.5 It is also critical to allow sufficient opportunity to address technical drafting issues. Given the complexity of the proposed changes, it would be unrealistic to expect that all drafting issues could be addressed at the Select Committee stage.

2.6 For example, the imported mismatch rule contained in Recommendation 8 will require the implementation of a number of tracing and priority rules in order to establish the requisite nexus between a hybrid deduction made by one taxpayer and an imported mismatch deduction made by another. These rules may (in order to address the complex interaction of New Zealand's rules with rules in other jurisdictions) need to be highly detailed. The level of complexity will in turn inform the workability of Recommendation 8 in the New Zealand context, and therefore whether it should be adopted by New Zealand.

Grandfathering (Submission Point 11E)

2.7 The proposed rules should not apply to arrangements entered into prior to the introduction of the Bill to Parliament containing New Zealand's legislative response to the OECD Report, for a number of reasons:

(a) First, the Discussion Document represents the Government's conceptual overview of the changes that may be introduced. A page titled "How we develop tax policy" on the Inland Revenue tax policy website describes the application of New Zealand's Generic Tax Policy Process. It states the role that discussion documents play in this process:

> Again, discussion documents, or 'white' papers in this case, may be used for purposes of consultation. Proposed reforms may be revised in light of the submissions received. This phase culminates in Government approval of practical tax policy initiatives that are ready to be introduced into Parliament and implemented.

That is, a discussion document does not and should not reflect the Government's finalised policy choices in respect of an issue. Rather, a discussion document is the start of a process for the Government to make in principle decisions about future reforms. Only following consultation on the Discussion Document and decisions by the Government on how it will proceed (in the form of a Bill introduced to Parliament or, at a minimum, an exposure draft of such a Bill) should taxpayers be required to assume that the law

will likely change when deciding whether to enter into a significant commercial transaction.

(b) Second, it should not be assumed that all existing transactions to which the proposals would apply are driven by tax rather than commercial considerations. The proposals in the Discussion Document would (as noted above) apply to a broad range of commercial arrangements. The tax treatment of such arrangements should not lightly be altered after they have been entered into.

(c) Third, Inland Revenue overestimates the significance of the fact that some (but not all) of the recommendations are limited to related parties and structured arrangements. Even in the case of transactions with related parties, there can still be third parties with significant interests in the arrangements which may not have any incentive to agree to restructuring of the arrangement if the burden of any increased tax liability falls on another party.

2.8 If (contrary to our above submission) the rules do apply to existing arrangements, then at a minimum:

(a) the proposed effective date for existing arrangements (the beginning of a taxpayer's first accounting period after enactment of legislation) should be extended to be a fixed date, one or more years after the enactment of any amending legislation; and/or

(b) there should be an exclusion or grandfathering for specific categories of existing arrangements (such as regulatory capital, as described below).

Exclusion for regulatory capital (Submission Point 5H)

2.9 The Discussion Document indicates (at page 1) that "the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches". In contrast, regulatory capital instruments meet regulatory requirements (administered in New Zealand by the Reserve Bank of New Zealand ("**RBNZ**")) for banks to maintain capital. The terms of such instruments are prescribed by the RBNZ. Regulatory capital instruments do not amount to what the Discussion Document describes as "deliberate exploitation of hybrid mismatches" and are therefore outside the mischief identified in the Discussion Document.

2.10 Given the importance of financial institutions being appropriately capitalised and properly regulated,[1] regulatory capital instruments should be excluded from New Zealand's implementation of the OECD recommendations. The OECD Report (at page 11) states that countries "remain free in their policy choices as to whether the hybrid mismatch rules should be apply to

[1] The OECD public discussion draft *BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* released in March 2014 ("**OECD Discussion Draft**") recognised (at paragraph 158) the "widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated".

mismatches that arise under intra-group hybrid regulatory capital".[2] Accordingly, New Zealand would be acting consistently with OECD recommendations were it to exclude regulatory capital instruments from its hybrid mismatch rules.

2.11 If regulatory capital instruments are not excluded from the implementation of hybrid mismatch rules in New Zealand, these instruments should receive the benefit of grandfathering in line with our submissions above. For the reasons set out above, grandfathering should apply to regulatory capital instruments issued before the date of introduction of any Bill to implement the OECD recommendations and/or Discussion Document proposals.

2.12 Grandfathering is particularly appropriate in the case of regulatory capital instruments. The main justification offered in the Discussion Document for no grandfathering is that the "rules generally apply to arrangements between related parties or within a control group [such that] restructuring arrangements should not be as difficult as it might otherwise be" (at paragraph 11.20). This justification is not applicable to regulatory capital instruments however.

2.13 First, in many cases, regulatory capital instruments are held by third party investors. Any redemption (even if possible) would affect third parties, which typically include retail investors. Second, to qualify as a regulatory capital instrument the terms of the instrument must require the issuer to receive prior written approval of the Reserve Bank of New Zealand to make any repayment of principal prior to maturity.

2.14 If regulatory capital instruments are not the subject of an exclusion or grandfathering, existing instruments would likely need to be refinanced. Given that multiple banks would likely need to refinance at the same time, it may be difficult to refinance all of the affected instruments.

Regulation-making power (Submission Point 11D)

2.15 If and when New Zealand does decide to adopt some or all of the OECD recommendations, we support the proposal (at paragraphs 11.18 and 11.19 of the Discussion Document) to permit the use of regulations to expand upon the detail of certain recommendations. A regulation-making power could also be used to manage the implementation of any hybrid mismatch rules in phases by only subjecting classes of financial instrument or entities to the hybrid mismatch rules as the impact of the rules have been fully considered.

2.16 Such regulation-making power would need to be subject to procedural safeguards to ensure that the regulations are not inconsistent with the primary legislation and are workable in practice. For example, it would be essential that exposure draft regulations be consulted on before being promulgated.

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[2] The reference to "intra-group hybrid regulatory capital" reflects the assumption in the OECD Discussion Draft (at paragraph 160) that regulatory capital issued to third party investors would be "unlikely to be caught" by hybrid mismatch rules.

3. OECD RECOMMENDATION 1 (FINANCIAL INSTRUMENTS)

3.1 Securities lending transactions between third parties are commonplace and generally not tax driven. Their prevalence has been recognised by the fact that New Zealand and many other countries have enacted tax rules specifically to facilitate such transactions.

3.2 The Discussion Document does not adequately address whether such transactions are within the scope of the Discussion Document proposals. Without a clear rule excluding such transactions, implementation of the proposals in the Discussion Document will further inhibit the ability of New Zealand taxpayers to enter into securities lending transactions. We submit that securities lending transactions with third parties should be excluded from the implementation of the hybrid mismatch rules.

4. OECD RECOMMENDATION 5.2 (LIMITING TAX TRANSPARENCY OF NZ ENTITIES WITH NON-RESIDENT INVESTORS) (SUBMISSION POINT 7D)

Foreign trusts

4.1 Recommendation 5.2 does not (contrary to Inland Revenue's suggestion at paragraph 7.29 of the Discussion Document) require New Zealand to tax the foreign-sourced trustee income of a New Zealand foreign trust to the extent it is not taxed in any other country. The fact New Zealand does not tax such income reflects the fact that the income does not have a New Zealand source. It is not the result of a hybrid mismatch of the type with which the OECD Report is concerned.

4.2 This is supported by comments made in the report arising from the Government Inquiry into Foreign Trust Disclosure Rules (June 2016) ("**Shewan Report**"), at paragraphs 4.15 and 4.17:

> The reforms were based on the core principle of taxing New Zealand residents on their worldwide income **and non-residents on income sourced from New Zealand. It follows from this principle that non-residents should not be taxed on non-New Zealand sourced income.** This was, and remains, orthodox international tax policy.
>
> [...]
>
> The Consultative Committee that recommended the settlor regime in 1988 **specifically recognised that one consequence of this approach would be that New Zealand would not tax the foreign source income of a resident who was the trustee of a trust with a non-resident settlor**. The Committee noted-
>
> > *In our view, this is the appropriate treatment since such income has no definite connection with New Zealand apart from the existence here of the trust administrator ... who will ... have no beneficial interest in the income.*
>
> [Emphasis added]

4.3 Inland Revenue's suggestion (at paragraph 7.29 of the Discussion Document) is also inconsistent with one of the conclusions of the Shewan Report, which was summarised at paragraphs 13.27 and 13.28 of the Shewan Report:

> The Inquiry concludes in Part 4 of the report that the current tax treatment of foreign trusts, **including the exemption from tax on foreign source income, is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy**. A repeal of the tax exemption, or other legislative changes aimed at closing the foreign trust industry down, would not be justified on policy grounds unless it was concluded that other options could not deal adequately with any problems identified.
>
> The Inquiry considers that, if adopted by the Government, the changes recommended to the disclosure rules will deal adequately with the problems identified, including reputational risk. **It does not recommend the repeal of the tax exemption** or other changes aimed at preventing the operation of foreign trusts in New Zealand.
>
> [Emphasis added]

4.4 The Shewan Report was an inquiry conducted this year that was specifically aimed at the foreign trust regime whose recommendations were adopted by the Government. If New Zealand were to now look to implement recommendation 5.2 in a manner inconsistent with the Shewan Report, it would suggest an incohesive and ad hoc approach to the formulation of tax policy, which could undermine confidence in New Zealand as a place to do business.

4.5 For New Zealand to tax non-New Zealand sourced income that is earned from capital settled by non-New Zealand settlors and that is not distributed to New Zealand resident beneficiaries would amount to taxation based on the formalistic criterion of a trustee (who's role is to administer and not benefit from the assets of the trust) being resident in New Zealand. Taxation by reference to such a formalistic criterion hardly seems consistent with the general philosophy underlying the OECD's BEPS initiatives.

Scope of other proposals

4.6 Inland Revenue's other proposals in respect of Recommendation 5.2 would significantly cut across existing domestic tax regimes and the scope of any such changes will need to be clearly set out and analysed before any decision to adopt them is made.

4.7 For example, in respect of the proposal to tax payments made to New Zealand look through entities (such as a limited partnership) that have some non-resident investors, it is not clear whether it is intended that the limited partnership ceases to be transparent entirely for New Zealand tax purposes, or whether New Zealand would tax only the income "attributable" to the foreign limited partners. In either case, there are likely to be a number of practical issues to work through (for example, the consequences of a disposal by a non-resident partner to a New Zealand resident partner, or vice versa).

5. OECD RECOMMENDATION 6: DEDUCTIBLE HYBRID PAYMENTS (SUBMISSION POINT 8)

5.1 The proposal to apply the deductible hybrid payments rule to foreign branches of New Zealand companies would have wide-reaching consequences for arrangements which would not normally be considered "hybrids". Indeed, a New Zealand business expanding overseas for the first time, operating through a branch in (say) Australia, could find itself subject to anti-hybrid rules intended to address "the deliberate exploitation of hybrid mismatches".

5.2 In particular, the proposal to apply the deductible hybrid payments rule to a foreign branch would restrict the ability for deductions to be claimed in respect of the foreign branch while the foreign branch is in a loss position. It will not be uncommon for New Zealand businesses seeking to expand internationally to be, at least initially, in a loss position in respect of their foreign operations. Any change that makes it more difficult for businesses to utilise such losses should be approached with caution.

5.3 The Discussion Document does propose certain measures to ameliorate the effects of, or to limit, the potential denial of deductions. In particular, the Discussion Document contemplates that:

(a) a foreign branch's loss could be deductible in New Zealand if it can be shown that the losses cannot be used to offset non dual-inclusion income in the branch country;

(b) a non-deductible loss could be carried forward;

(c) an active income exemption could be introduced.

5.4 However, none of these solutions is perfect, and each can be expected to increase tax costs (for example, the risk of stranded losses where losses are carried forward), or compliance costs, for New Zealand businesses seeking to expand overseas.

5.5 If the decision is made to adopt Recommendation 6 and apply the hybrid payments rule to branches, then each of the measures set out at paragraph 5.3 above, including the active income exemption, should be adopted.

6. OECD RECOMMENDATION 7: DUAL-RESIDENT PAYERS (SUBMISSION POINT 9A)

6.1 Dual resident taxpayers should be denied a deduction in one jurisdiction only. To deny a deduction in both jurisdictions is punitive. We do not accept Inland Revenue's assertion that "dual residence status is in most cases deliberate rather than accidental" (Discussion Document, paragraph 9.3).

6.2 The assertion that dual residence status is most often deliberate rather than accidental is unsubstantiated and, in our view, unlikely to be correct. The four bases of residence for companies mean that there are a number of ways in which a company can become resident in New Zealand. Some of these are not clear cut, and it is entirely possible for a company to become

resident accidentally (for example, if it is incorporated in one country, but for commercial reasons has some executives or directors located in another).

6.3 The recommendation to deny a deduction for such entities in both jurisdictions seems to follow from the assumption that these entities have made a deliberate choice to be dual resident, and is effectively punitive. We submit that a better approach would be to deny a deduction in only one of the jurisdictions.

7. OECD RECOMMENDATION 10: DEFINITION OF STRUCTURED ARRANGEMENT (SUBMISSION POINT 12)

7.1 The definition of "structured arrangement" is an important definition in the context of the Discussion Document proposals. In most cases the proposals will not apply to transactions with third parties unless the transaction is a "structured arrangement". Consequently, it is critical that the definition of "structured arrangement" is clearly defined. An ill-defined or unduly expansive definition of "structured arrangement" will result in the hybrid mismatch rules potentially applying to transactions outside the intended scope of the OECD Report.

7.2 The Discussion Document proposes to define a structured arrangement as one where either (paragraph 12.7 of the Discussion Document):

(a) the hybrid mismatch is priced into the terms of the arrangement; or

(b) the arrangement has a purpose or effect of producing a hybrid mismatch.

7.3 In the context of section BG 1, Inland Revenue's Interpretation Statement IS 13/01 provides (at paragraph 192):

> The purpose or effect of an arrangement, including any tax avoidance purpose or effect, is determined objectively. The taxpayer's intentions are not relevant. "Purpose", in the context of tax avoidance, means the intended effect the arrangement seeks to achieve and not the motive of the parties. "Effect" means the end accomplished or achieved by the arrangement. ...

7.4 A "purpose or effect" test, as contained in the second bullet point of paragraph 12.7 of the Discussion Document, would suggest that any transaction that on its terms gave rise to a hybrid mismatch would be a "structured arrangement". The "structured arrangement" criterion would therefore add nothing. Every arrangement that gives rise to a hybrid mismatch would be a structured arrangement. This would expand the scope of New Zealand's hybrid mismatch rules radically beyond the scope of the OECD Report recommendations which are intended to be limited to structured arrangements (and/or arrangements between related persons).

7.5 For completeness, we note that the Discussion Document does not discuss (or indicate inclusion in any domestic law definition) Recommendation 10.3. Recommendation 10.3 excludes a taxpayer from the definition of structured arrangement where neither the taxpayer nor any member of the same control group could reasonably have been expected to be aware of the

hybrid mismatch and did not share in the tax benefit resulting from the mismatch. This specific exclusion should be included in any domestic definition of "structured arrangement".

Yours faithfully
RUSSELL McVEAGH

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#016

Addressing hybrid mismatch arrangements
c/- Deputy Commissioner, Policy and Strategy
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PO Box 2198
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Sent by email: policy.webmaster@ird.govt.nz

11 November 2016

Addressing hybrid mismatch arrangements

Dear Sir/Madam

We appreciate the opportunity to comment on the Government discussion document *Addressing hybrid mismatch arrangements* released 6 September 2016.

Submissions

In addition to our initial submission comment in this paragraph, we set out below five other submission points which we believe the Commissioner should consider in the interest of providing clarity to a wide range of taxpayers.

1. *We have kept the submission points deliberately high level as one of our key overall submission points and concern is that a lot more detail around the design and outline of the legislative provisions is needed. Once provided, we will be in a position to give proper consideration to the design of the wide ranging and multi faceted proposals which impact many areas of the tax legislation.*
2. *New Zealand should not be one of the first wave of "early adopters" and should not implement the hybrid mismatch arrangement rules prior to a reasonable proportion of OECD countries enacting the rules.*

It is our view that, at a minimum, the timing of implementation should be coordinated with other OECD jurisdictions to ensure New Zealand is not in the first wave and, if necessary, deferred until the majority of countries with a New Zealand taxation connection, such as those with capital funding into New Zealand, have implemented the anti-hybrid rules. We consider there to be little advantage for New Zealand being an early adopter and effectively acting to close down tax mismatches that are usually caused by the specific tax rules in other countries rather than in New Zealand.

The discussion document references rules to come into effect in the UK and Australia. Our understanding is that the implementation of such rules in Australia is likely to be behind the timetable referenced in the discussion document, and draft legislation has not yet been worked on in any detail. We also consider it likely that the legislation actually enacted in a number of countries will be

materially watered down or countries will have other features in their overall tax regimes so that they remain internationally attractive to multinational groups. We consider it very prudent for New Zealand to watch and observe and ensure that the tax rules that we enact in New Zealand do not end up disadvantaging New Zealand from an overall international competitive perspective compared to the tax rules that actually end up being implemented in our major trading partners.

The successful implementation of the OECD recommendations regarding hybrid mismatch arrangements released in late 2015 are hinged on the precondition that most countries will adopt the rules. The United States has indicated they will not adopt the OECD recommendations and despite the "expectation that countries that are part of the consensus will act", there is no guarantee whether, or confirmation when, these other countries will take real action and introduce significant law changes.

Advancing with the implementation of these rules, based only on the presumption that the rest of the world will match these actions and in a pure and consistent way based on the OECD recommendations, exposes New Zealand taxpayers to substantially increased costs of tax compliance and administration without the guarantee of reciprocity made in counterparty jurisdictions. New Zealand should not place itself in a position to be the "world tax police", left responsible for monitoring cross-border transactions to ensure that the correct amount of tax is collected globally. The tax base of New Zealand may not be significantly benefited where taxpayers restructure such arrangements prior to the introduction of these rules – for example, replacing interest deductions arising from a hybrid financial instrument with interest deductions arising on a "vanilla" debt instrument. Rather, the focus needs to be refined so that consideration is also given to the overall competiveness of New Zealand's tax system in light of these proposals and accordingly the long term impact on the New Zealand economy.

We request that the Government and the Commissioner consider a more appropriate delayed timeframe for implementing any of these rules in New Zealand, with particular reference to the timing and implementation of the rules in other jurisdictions.

This is particularly true for the proposed imported mismatch rule. To the extent that such rules are determined to be required in New Zealand (which we doubt is really needed weighing up all the factors), at a minimum, New Zealand should phase in this complex tax burden following the introduction of the rules by our key trading partners. As noted by the Board of Taxation in the review of implementation of the imported mismatch rule in Australia, such rules would give rise to "considerable compliance challenges", would be "difficult to administer", and would place "unfair compliance burden on [Australian] entities". In our view New Zealand should not implement the imported mismatch rule.

3. *Targeted domestic tax rules to address specific concerns, such as the foreign dividend exemption provision, would be a more pragmatic option in the short term given the relative urgency expressed in the discussion document for the introduction of anti-hybrid rules*

The complexity of the proposed rules, as discussed further below and discussed with Inland Revenue Policy officials in several different forums over the last month or more, is indicative of how challenging the underlying objective ultimately is. We understand the political drivers behind the proposed changes (and we consider the political pressure to be seen to be acting at the head of the pack is dangerous and slightly naïve given New Zealand's economic position as needing foreign investment to

continue to grow). Therefore, we urge that the detailed design of these rules not be rushed in New Zealand so that there is sufficient time to work through the intricacies and observe how a number of other countries actually implement the rules, to assess how they interact with the various regimes in the existing legislation and to allow for undue complexities to be reduced as much as possible.

Targeted and specific rules can more easily be isolated and examined so that each knock-on effect can be thoroughly, and responsibly, explored. The discussion document concedes in section 3.17 that "the New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown". Additionally, the same section suggests that the tax revenue at stake in relation to funding arrangements comparable to the *Alesco* arrangement is approximately $300 million. However, the *Alesco* case involved no loss of revenue, because if the purchase had been funded by ordinary interest bearing debt (rather than the hybrid, Optional Convertible Note) the same interest deductions would have been claimed by Alesco New Zealand. We urge that the overall benefit to New Zealand be carefully modelled to maintain the integrity of the New Zealand tax system. Further, these benefits should be weighed up against the cost of new rules to substantiate their introduction.

Further, we note that the majority of hybrid financing arrangements such as *Alesco* are a feature of the past given the dramatically changed tax risk environment in New Zealand in recent years. This needs to be factored in to ensure the complexity of the rules far outweighs the practical relevance in New Zealand going forward.

We request that the Commissioner delay the introduction of wide sweeping rules and instead prioritise certainty above all else. Alternatively, while awaiting the introduction of hybrid rules in overseas jurisdictions, targeted New Zealand tax rules could be implemented that capture a specific hybrid structure or instrument that has been identified by Inland Revenue as particularly concerning in a New Zealand context (such as the extension of the carve out to the foreign dividend exemption in CW 9 mentioned in the paper).

4. *The current level of complexity of the proposed rules means they will be hugely difficult for taxpayers to interpret and comply with in practice*

The theoretical benefit of the proposed rules is significantly impeded by their complexity. Taxpayers will have to go to extraordinary efforts and ongoing cost, not only to understand how the new rules will apply to their business, but also to acquire a detailed understanding of the tax law in each counterparty jurisdiction before the new rules can be correctly applied. We are concerned that the complex nature of the proposed rules will lead to increased compliance costs for both taxpayers and tax administrators.

For example, with regard to hybrid financial instruments, the rules require taxpayers to understand in the counterparty jurisdiction the ordinary tax treatment of a payment; whether a deduction would be denied or participation exemption switched off; and anticipate the future tax treatment of the payment to determine whether the mismatch is purely a timing difference. This is only one simplified timeline of events. There will inevitably be unforeseen complexities that disrupt this logical sequence. One example of an unforeseen complexity is where the New Zealand taxpayer denies a deduction in New Zealand after identifying a mismatch in the counterparty jurisdiction; at a later point in time the tax authority in the counterparty jurisdiction disputes the tax treatment of this income; the income is subsequently deemed to be taxable. The New Zealand taxpayer that has complied with the rules is left

disadvantaged unless the income tax return that corresponds to the denied deduction is reopened and corrected.

The proposed ability to carry forward disallowed deductions to offset against "dual inclusion income" (which in itself is a complex concept and will need careful drafting to be understandable) in future years is intended to benefit taxpayers by preventing double taxation but the discussion document does not consider how this will be achieved practically. It assumes New Zealand entities will have the ability and capacity to track disallowed deductions in New Zealand going forward together with the corresponding receipt in the counterparty jurisdiction. We support the fairness that this proposal is seeking to achieve, however we are concerned that the difficulty and increased compliance burden associated with tracking the treatment of two amounts in two different jurisdictions will ultimately result in double taxation.

We consider that making the hybrid mismatch rules sufficiently difficult so that businesses are encouraged to use simpler structures, which do not require the rules to be applied, is not an appropriate justification for their complexity. There are valid commercial reasons for establishing such structures and these should not need to be discarded in exchange for the possibility of eliminating mismatches. Given the complexity of the issue, the rules should not be designed solely with taxation outcomes in mind.

We request that the Commissioner make every effort to ensure future communication of the proposed rules is presented in a way that the practical impact can be better understood by taxpayers. Supporting guidance in a second round of consultation (before draft legislation going into a Tax Bill) in the form of detailed commentary and design of the provisions needed should be provided to assist taxpayers to navigate the proposed rules in a way that is not dependent on a high level of tax technical knowledge. The rules should be effective at disqualifying inappropriate advantages but not at the expense of the integrity of New Zealand's tax system or New Zealand's investment.

5. *The implied ability of New Zealand taxpayers to access sufficient information to comply with the proposed rules is inconsistent with commercial and practical reality and does not contemplate the barriers that New Zealand taxpayers are likely to encounter in practice*

The discussion document comments in relation to accessing information that "[...] the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context."

We strongly disagree with the assumption that a New Zealand member of a control group will be able to easily access information and we are concerned that otherwise compliant New Zealand taxpayers will be unable to proffer sufficient information to comply with the proposed rules. Often, New Zealand corporates are at the "bottom of the chain" and are materially insignificant relative to other members of wider corporate groups. In this inbound context, requests for information from New Zealand are unlikely to be prioritised by global tax managers or executive groups. It will be particularly difficult to communicate the sudden need for certain information from counterparties in jurisdictions that do not have equivalent hybrid rules in place.

We expect that this problem will only be exacerbated outside of a wholly owned group scenario. Joint ventures will also be classified as under common control under proposals (i.e. a 50% test) and is an

example of a situation where accessing information will not be a straight forward exercise. Others can be seen in the proposed CFC and FIF changes, which apply to "related entities", i.e. a 25% test.

From a practitioner perspective, lack of available information is also a concern. The proposed rules as they stand assume ease of access to detailed information, which may not always be possible, particularly in other jurisdictions that have tighter disclosure restrictions and generally less information transparency. In providing New Zealand tax advice, practitioners would be required to understand how counterparty jurisdictions throughout the chain treat the concerned payment and supporting information will also be required to substantiate advice provided. In practice this type of information is often legally privileged and therefore inaccessible without the risk of losing such privilege. We consider the expectations that the proposed rules will put on New Zealand practitioners to be contradictory to what has been established as good practice; New Zealand tax advice should be based on New Zealand tax legislation.

We request the Commissioner clarify what extra information will be required to support positions taken when filing a New Zealand income tax return and address how such information will be collected (e.g. through the Exchange of Information Agreement), particularly where rules prohibit its disclosure.

6. *Supplementary guidance and detail required before the full impact of each distinct rule can be adequately contemplated and to facilitate comprehensive discussion*

The complexity of the rules and the sweeping application that they are intended to have justifies the need for an in-depth analysis to determine all resulting implications. We do not consider the current guidance, nor the timeframe provided, sufficient to allow complete comments to be provided on each of the upwards of 25 submission points. There are a number of issues that have been left open by the document with an ask for taxpayers and practitioners to comment on and we are concerned that each of these will not be given the careful consideration that they require. We consider Inland Revenue needs to do a lot more thinking on the design of the rules and key aspects of the proposed legislative rules and then ask for consultation and feedback again.

The discussion document also makes certain assumptions that should be considered further. For example, in considering dual resident entities, the paper states that dual resident entities arise as a result of tax planning. In our experience, this is generally not the case, and instead is more likely to arise through innocuous actions, where taxpayers have inadvertently relaxed governance procedures, resulting in dual resident status. Given the practical reality of such arrangements, the proposal to remove the Place of Effective Management test will likely put pressure on competent authorities, requiring significant additional resources for this work to be undertaken and significant time delays. Our view would be to retain the current tie breaker test.

Additionally, the discussion document does not appropriately address the interaction of the proposed hybrid rules with New Zealand's existing tax rules. The impact on New Zealand's withholding tax, thin capitalisation and transfer pricing regimes is noted only at a high level. The implications for these proposed changes should be further outlined for taxpayers' consideration, and in particular, should ensure that a consistent approach is taken for the hybrid rules as are currently in our tax rules. For example, the tax outcome of the hybrid proposals for a hybrid instrument seek to "disallow deductions" claimed, effectively re-characterising the instrument as equity for tax purposes (similar to a section FA 2 debenture). However, it is proposed that interest withholding tax would still be payable

on the disallowed interest. We have major concerns with this. This can be contrasted with the thin capitalisation rules that acknowledge the interest deductions claimed but seek to deem interest income to arise to the New Zealand taxpayer where the safe harbour thresholds are exceeded, which seems much more rationale.

In relation to the transfer pricing implications of the proposed rules, other than the high level comments provided in paragraphs 11.5 and 11.6, we are uncertain how the rules would operate where the transfer pricing methodology used in the counterparty jurisdiction differs from that used in New Zealand. In practice, we are aware that interest rate pricing often varies between jurisdictions with different levels of "safe-harbours" and expectations with respect to the level of interest rate pricing analysis undertaken. Although there is no mismatch with regard to the treatment, clarification is required in relation to how the difference in the two "arms-length" amounts should be treated (i.e. is the New Zealand taxpayer required to include an additional income top-up to account for this difference?).

The Commissioner should provide additional guidance to support the proposed rules, once they have been more fully developed, and which considers the resulting implications of the fundamental shifts in practice that will need to take place to facilitate compliance with the rules.

General

We trust these high level comments are useful and we look forward to providing more detailed comments on a further round of consultation once more thinking and design and high level drafting of the different points are worked on by Inland Revenue and circulated for further comment and consideration.

Yours sincerely

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Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
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11 November 2016

Email: policy.webmaster@ird.govt.nz

Dear Sir

Submissions on *Addressing hybrid mismatch arrangements* discussion document

We refer to the discussion document, *Addressing hybrid mismatch arrangements*, which was released for consultation on 6 September 2016 ("DD"). We appreciate the opportunity to comment and do so below and, in more detail, in the attached Appendices.

We do not see the proposals in the DD ("Hybrid Rules") as being suitable for enactment in their current form. Instead we recommend that New Zealand's overall approach is reconsidered. We have therefore taken a selective approach when choosing whether to respond to the specific questions posed for submission.

Given the complexity of the proposals, we suggest that a further consultation round with detailed draft legislation is carried out before final decisions are made – rushing legislation into a Bill in early 2017 would be premature.

Executive Summary

In terms of process:

- Before making any decisions regarding the proposals in the DD, the Government should explicitly assess the proposals against its published Revenue Strategy and also against the overarching goal for New Zealand's tax system of maximising the welfare of New Zealanders.

- New Zealand should not be an early adopter of anti-hybrids measures as international norms have yet to materialise.

- Consideration should be given to a less complex package of measures targeted at known problems rather than a wholesale importation of recommendations designed for tax systems and economies very different to New Zealand.

- Existing arrangements should be fully grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting period should be the absolute minimum requirement.

Our selective comments on the substance of the proposals should be read subject to our overall view that the proposals as a whole should not be enacted in their current form:

- New Zealand taxpayers, generally at the bottom of the chain for multinational enterprises, will find it difficult to obtain sufficient information to comply with the primary rule.

- All decisions in respect of branch structures, in particular whether there should be an active income exemption for foreign branches of New Zealand companies, should be deferred until the OECD has finalised its recommendations regarding branches.
- New Zealand should not enact legislation to deny a deduction for amounts paid under frankable/deductible instruments on the grounds that there is no hybrid mismatch against which such action can be justified.
- The use of imputation credits to reduce tax on a dividend which is deductible to the payer should not be denied.
- The primary rule should not apply to deny deduction where tax has been imposed in the hands of the payee's owners under a Controlled Foreign Company ("CFC') regime.
- Regulatory capital should be excluded from any hybrid rules.
- The commercial consequences of the proposals should be examined in more detail before final decisions are made.
- There should be some clarification around the existing concept of a "segment" of income for foreign tax credit purposes.
- The proposed rule to ignore imputation credits when applying the secondary rule to hybrid dividends should not proceed.
- Timing differences should not be subject to the Hybrid Rules. In the event that submission is rejected, then greater thought should be given to the merits of the United Kingdom test and/or to lengthening the period over which timing mismatches are acceptable to longer than three years.
- The transfer of assets should not be subject to the rules, therefore the question of an exemption for revenue account holders is not relevant.
- There should be an objective test which taxpayers can apply in assessing dual residence, e.g., place of effective management.

With regards to design principles, should the package proceed:

- Non-resident withholding tax ("NRWT") should not be charged on an interest payment for which deduction has been denied.
- The proposals should not be subject to the general anti-avoidance rule ("GAAR") due to the level of uncertainty this will cause.
- The proposals should be contained in primary legislation rather than subsidiary regulation.
- An amendment to the taxpayer secrecy provisions in s 81 of the Tax Administration Act 1994 will be required to enable Inland Revenue to release necessary information to counterparties.
- Inland Revenue needs to examine the interaction of the time bar provisions within s 108 of the Tax Administration Act 1994 with the proposals.

We would be happy to discuss any aspect of our submissions with you. Please contact David Snell (david.snell@nz.ey.com) in the first instance in that regard.

Yours faithfully

Aaron Quintal
Partner – Tax Advisory Services
Ernst & Young Limited

Appendix A - Process

Need to address Action 2 of the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Action Plan

The Government has supported the OECD/G20 BEPS Action Plan. Given that support, we agree that the relevance of the Action 2 recommendations to New Zealand should be assessed. We agree with the Minister of Revenue who has stated:

> *"First, we need to ensure our own domestic tax laws are robust and consistent with international best practice. This is to ensure that our domestic tax settings protect our tax base and do not facilitate double non-taxation, tax avoidance or evasion."*[1]

We also acknowledge:

- The immense challenge for any organisation or group of countries to design and achieve widespread acceptance and implementation of any set of income tax rules that will operate coherently and symmetrically between or among different jurisdictions.
- The various OECD/G20 BEPS Action Plans, as finalised in October 2015 contain numerous and ambitious proposals and recommendations to that end.
- New Zealand wants to be seen to be doing the right thing in terms of the international tax community.

Absence of clear framework for proposals

We submit that the Government should explicitly assess the proposals against its published Revenue Strategy[2] and also against the overarching goal for New Zealand's tax system of maximising the welfare of New Zealanders. [3]

An enduring strength of New Zealand's tax system has been its clear framework, with an emphasis on coherence, economic efficiency, equity, and ease of compliance and administration within a broad-base, low rate structure. The Government's Revenue Strategy, reproduced in part below, reinforces those aims.

We have particular concerns that the proposals are not planned and coherent, may bias economic decisions and have high compliance and administration costs. It is not clear from the DD precisely how the wholesale implementation of all Action 2 recommendations is consistent with the Government's Revenue Strategy. What does seem clear is that any such wholesale implementation will cut across many general principles and concepts in the framework of New Zealand's domestic income tax system.

The only references to a framework in the document are to current problems with the "global international tax framework". We accept that the proposals seek to minimise opportunities for tax avoidance and evasion, but they do so in an arbitrary manner and are in any event unlikely to succeed.

[1] *Base Erosion And Profit Shifting (BEPS) – Update on the New Zealand Work Programme*, Cabinet Paper, May 2016, paragraph 24.
[2] "The tax system should be as fair and efficient as possible in raising the revenue required to meet the Government's needs. The Government supports a broad-base, low-rate tax system that minimises economic distortions.

The Government considers these goals are best supported by a tax system that:

- maintains revenue flows to pay for valued public services and reduce debt
- responds to New Zealand's medium-term needs in a planned and coherent way
- biases economic decisions as little as possible - which allows people to work, save, spend or invest in ways that they believe are best for them
- rewards effort and individuals' investment in their own skills
- has low compliance costs and low administrative costs
- minimises opportunities for tax avoidance and evasion, and
- shares the tax burden as fairly as possible."

See Government 2016 Revenue Strategy at http://www.treasury.govt.nz/government/revenue/strategy

[3] As set out in *New Zealand's taxation framework for inbound investment: A draft overview of current tax policy settings* (June 2016), pp 3-4.

When making decisions on the merits of the proposals when compared to New Zealand's framework, we would like to highlight:

- The absence of consideration of the Government's intentions in terms of New Zealand's tax base, other countries' tax bases and the lack of a clear purpose for each specific proposed legislative measure. We do not favour additional legislation unless the case for it has been made.

- The denial of tax deductions or imposition of tax charges could increase the cost of capital in New Zealand. We could become a less attractive place for inbound investment. This outcome appears contrary to ensuring that taxes from inbound investment are as fair and efficient as possible and that New Zealand remains an attractive place to invest and base a business. It is inconsistent with the Minister of Finance's undertaking at the time of the OECD/G20 BEPS Action Plan Final Reports that:

  > *"We need to always consider the effect that tax policy has on the productive sector of the economy. Decisions have to be made as to what extent the OECD recommendations are applicable to New Zealand and the best way to implement them, giving thought to matters such as compliance costs."*[4]

- Selective denial of deductions is likely to increase distortions by effectively preventing investments from being financed in ways that are most efficient and undertaken by those who can do so most efficiently.

- New Zealand depends on inbound investment, with a degree of leverage inevitable. It is possible to argue that hybrid instruments are the means by which leverage is introduced in New Zealand, as opposed to the driver for that leverage. Implementation is therefore likely to lead to less efficient ways of introducing debt into New Zealand rather than to any material increase in the overall tax take.

- The proposals have a potentially negative impact on New Zealand's capital markets. The very existence of a set of rules designed to counter hybrid mismatch outcomes is likely to influence taxpayer behaviour so that, most obviously perhaps, New Zealand taxpayers will ensure their future borrowings from related parties are by way of straightforward loans.[5] This is not necessarily a desirable outcome: there is an investor demand for high quality investment opportunities and for investments with a risk profile between that of debt and of equity. It is possible that the quality and range of investment opportunities in New Zealand will reduce.

How far should international co-operation drive implementation?

We submit that New Zealand should not be an early adopter of anti-hybrids measures as international norms have yet to materialise.

The OECD/G20 recommendations are not mandatory minimum standards which member countries are obliged to enact unchanged in full. New Zealand is permitted to amend our policy response to match our domestic and economic objectives.

With regard to our BEPS-related objectives, the Government has categorised these as being that all taxable income earned in New Zealand should have tax paid in New Zealand, all gross revenue earned in New Zealand should be identified and reported; and deductions from gross revenue should reflect the real economic costs of production, free of measures deliberately designed to reduce tax liability.[6] The Government has previously stated that "*our approach is to be mindful of the tax system as a whole and to take a considered approach*".[7]

In substance, the Government's policy appears to be to support BEPS measures which help to ensure that multinationals pay the right amount of tax in New Zealand, but to follow rather than lead international norms. Government policy can best be served by learning from other countries and acting selectively. To date, however, only the United Kingdom, Australia and the European Union have put forward measures in

[4] Media statement *OECD releases full BEPS action plan* by Minister of Finance and Minister of Revenue, 6 October 2015 http://taxpolicy.ird.govt.nz/news/2015-10-06-finalised-beps-action-plan-released (as accessed on 16 September 2016)
[5] Introduction, page 1.
[6] *Base Erosion and Profit Shifting (BEPS) – Update on the New Zealand Work Programme*, Cabinet Paper, May 2016, paragraphs 3 and 4.
[7] Hon Todd McClay, former Minister of Revenue, Address to CAANZ Annual Conference, 19 November 2015.

respect of Action 2, with only the United Kingdom reaching the stage of enactment. Significant sources of inbound investment such as the United States, Singapore, Canada, China and Japan have yet to take any action, nor has any Asia-Pacific country outside Australia and New Zealand. Countries such as Germany have consciously deferred decisions. There are as yet no international norms.

New Zealand's unicameral system and stable government means that we are at real risk of leapfrogging almost all of our investment partners in enacting and implementing any Hybrid Rules. As New Zealand is not a major financial centre and few New Zealand businesses drive intra-group funding arrangements or group structuring decisions, early adoption makes little, if any, sense.

Approach is overly complex

We submit that a less complex package of measures targeted at known problems should be considered rather than a wholesale importation of recommendations designed for tax systems and economies very different to New Zealand.

Consistent with OECD recommendations, the proposals are complex. They encompass a set of primary and secondary rules and defensive responses, with different rules for each of the hybrid arrangements covered. This interlocking matrix seems more complicated than any domestic law regime of any country in place prior to the United Kingdom's adoption of anti-hybrid measures.

Moreover, it envisions the global adoption of rules that must then mesh across the two or more countries involved in any particular transaction or arrangement. It does not seem possible that all countries will adopt this framework consistently.

This means the proposals involve substantial uncertainty and significant risk of double taxation.
There is also a significant overlap between the proposal on addressing hybrid mismatch arrangements and the Government's ongoing work on limiting interest deductibility under Action 4.

This degree of complexity is not needed for the New Zealand tax environment. New Zealand already has robust existing rules and Inland Revenue has a strong track record in winning disputes regarding hybrid arrangements.

We suggest that this complexity and overlap leads to:

- The need to consider a more selective, simpler approach targeting known problems rather than a catch-all approach with unknown effects.
- The desirability of putting forward the Hybrid Rules and interest limitation proposals as a single package so that their combined impact can be assessed and trade-offs made.
- A need to examine the interaction of the proposals with the terms of New Zealand's double tax agreements.

Effective date for introduction of new rules (Submission point 11E, page 78)

We submit that existing arrangements should be fully grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting period should be the absolute minimum requirement.

Investors have entered into hybrid mismatch arrangements on the basis of existing law, with such arrangements having been priced on that basis. To amend existing structures, in particular hybrid financial instruments, would be inefficient and may cause otherwise desirable inbound investment to cease. We are particularly concerned regarding the impact that a failure to grandparent current investments may have on the ability for New Zealand business to attract future inbound investment.

The DD states that "*the rules generally apply to arrangements between related parties or within a control group*"[8], suggesting that restructuring may not be too difficult. This will not always be correct. Some hybrid financial instruments will be issued to third parties, widely held and listed on a recognised exchange. They will only be subject to the proposals because of the intended broad definition of structured arrangement.[9]

The DD goes on to state that the result should not generally be punitive, rather involving the loss of an unintended tax benefit. Given the wide scope of the proposals, it is not correct to state that the tax benefit is unintended – it can be a deliberate design feature within a country's tax legislation.

We also note that unwinding a hybrid entity arrangement, particularly a structure involving limited partnership, can be challenging and potentially costly if not properly planned. In many cases, unwinding such structures may involve a significant legal entity restructure.

Finally, the DD also states that the impact of the proposals will in most case be able to be established now, by reference to the OECD/G20's Final Report on Action 2 ("Action 2 Report"). We doubt that outcome is realistic, particularly in the many less obviously "hybrid" situations which we anticipate could fall within the extremely broad scope of all the Action 2 Report recommendations. We consider any assumption that OECD/G20 recommendations should be deemed to represent New Zealand law on complex, large, economically significant transactions, in advance of any government decisions on the matters in question, would be an abuse of due process. Decisions regarding New Zealand law should be made by Parliament, not asserted through discussion documents.

If more targeted rules are not applied there should be a considerable grandparenting provision or a period during which restructuring of hybrids can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise. This is consistent with the proposed application of NRWT or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill.[10] We also note that transitional arrangements proposed for measures in connection with employee share schemes will extend until 2022.[11] The financial impact of unwinding complex hybrid instruments far outweighs that of changes to employee share schemes.

[8] See paragraph 11.20 at page 78.
[9] See paragraph 12.5 to 12.7 at pages 80-81.
[10] See clauses 5(4)(a), 5(4)(b) and 5(6) of the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill, which cover lending from a third party with a New Zealand branch, a foreign parent with a New Zealand branch and bank wholesale funding respectively
[11] See *Tax treatment of employee share schemes – further consultation* (September 2016), paragraph 38 at page 13.

Appendix B – Substance of proposals

Difficulty in complying with primary rule

We submit that New Zealand taxpayers, generally at the bottom of the chain for multinational enterprises, will find it difficult to obtain sufficient information to comply with the primary rule.

The Action 2 Report proposes two-tier rules in a number of its recommendations. The primary rule is that the payer country would deny deductions. The secondary rule is that the payee country would include payments received in taxable income. Claiming deductions would depend on payers knowing or being able to ascertain that their payments would be fully taxable in recipients' jurisdictions.

We consider there are at least two substantial issues with such proposals:

- Possible difficulties and cost for payers in determining the treatment of their payments in recipients' jurisdictions, especially if they are required to consider the tax treatment (including treatment of any tax credits) of any possibly connected payments for any recipients beyond their direct and immediate payees or the controlled foreign company ("CFC") treatment of ultimate owners in overseas jurisdictions. Expecting New Zealand taxpayers to be able to provide proof of actual taxation of amounts under the CFC rules of overseas jurisdictions is unreasonable.

  Differences between payer and payee countries, for example, in relation to treatment of leases and the treatment of foreign exchange variations would seem to make for additional complexity for New Zealand taxpayers who may have to isolate the amounts at risk from calculations ordinarily performed under New Zealand's domestic laws for financial arrangement accrual expenditure and leases. Differences in the timing of recognition between payer and payee countries would also seem to add to New Zealand taxpayers' tax compliance burdens.

  Countries' domestic tax laws cannot be assumed to remain static. Accordingly it would not be sufficient for a payer to ascertain the recipient country tax treatment as a one-off matter. Rather, at least annual review and checking would be needed over the total period a possibly affected instrument, structure or arrangement is in force.

- Possible circularity of contingencies. The application of the primary rule depends on the recipient country's treatment, but the latter may depend on the deductibility or otherwise in the payer country. It does not seem clear which country's provisions should apply first if each country has provisions which apply if the item is treated in a particular way in the other country. New Zealand's s CW 9 provides an example in that it taxes foreign dividends derived by a New Zealand resident company from a non-resident company if they are deductible (directly or indirectly) overseas. What would happen, however, if the overseas deduction depended on whether or not the item was taxable or exempt in New Zealand?

These concerns may particularly impact merger and acquisition activity. Hybrid entities and instruments are a common feature of private equity structures, with a need to review structures to determine if they give rise to *deduction no inclusion* ("D/NI") outcomes.

However, the nature of international tax financing is that in many cases this will be extremely difficult. Taxing cross border financing is inherently complex and the means by which taxation (or deductibility) occurs is often nuanced and territory specific.

This will not be a one-off exercise. Changes required to domestic laws will likely be adopted at differing times, increasing uncertainty as to the level of value available from financing costs and bringing into focus the sustainability and durability of transaction structures.

Establishing a robust position for a New Zealand taxpayer will require a level of understanding around the foreign outcome. This burden becomes increasingly onerous where such an outcome occurs pursuant to detailed legislation, specific concessionary treatment or under principles not recognized in New Zealand law (such as taxation of chargeable gains).

Building a better working world

Overreach of proposals

The Action 2 Report comments (paragraph 13) that the only types of mismatches targeted by its report are those that rely on a hybrid element to produce mismatches, such as differences between transparency and opacity of an entity for tax purposes or differences in the characterisation of instruments. It appears, however, that the potential scope of any changes may be much broader than those ordinarily seen as falling within those categories. Almost any difference in income tax treatment of any transaction between parties in different countries appears to be under attack.

Examples of areas where we have concern include:

Branches (Submission point 8, page 64)

We submit that New Zealand should defer any decisions in respect of branch structures, in particular whether there should be an active income exemption for foreign branches of New Zealand companies, until the OECD has finalised its recommendations regarding branches.

The tax treatment of branches, in particular the possibility of an exemption for active income earned through a foreign branch, is an important topic. It should be given separate consideration rather be seen as a by-product of anti-hybrid measures. We also note:

- There is a lack of clarity in the DD regarding the treatment of New Zealand branches, which appear possibly to fall within the requirements to be a disregarded hybrid payment structure. The DD notes that "*no characteristics in and of themselves would qualify an entity as a hybrid payer*" and that "*an entity that is considered to be a hybrid payer in one scenario may not be a hybrid payer under a different scenario*".[12]

- The DD was released shortly after the OECD released its Discussion Draft regarding branch mismatch structures. We are not clear on the extent to which the DD is intended as a response to these recent proposals, which should be fully considered before New Zealand makes any decisions regarding hybrids.

- Hybrid mismatch situations targeted by the Action 2 Report relate to the use of hybrid instruments and entities, whereby the use of such hybrid entity or instrument is frequently at the choice of the taxpayer. Such is not the case for branches. Whether certain activities constitute a permanent establishment is purely dependent on the threshold for recognising taxable presence in a country where a foreign taxpayer's business activities are conducted.

Frankable/deductible instruments

We submit that New Zealand should not enact legislation to deny a deduction for amounts paid under frankable/deductible instruments[13] on the grounds that there is no hybrid mismatch against which such action can be justified.

The assertion that *"there is no practical distinction between exemption and full imputation"*[14] is incorrect. Amounts paid to investors in frankable/deductible instruments are fully taxed in the investors' hands and in no way exempt. Any difference is one of timing only. The franking credits attached represent underlying Australian tax paid and are therefore no longer available to be attached to other profit distributions. The instrument does not produce a D/NI result.

[12] See paragraph 6.7 at page 47.
[13] See paragraph 2.14 at page 11.
[14] See paragraph 5.5, at page 32.

While we appreciate that that the DD's analysis of frankable/deductible instruments is consistent with that in the Action 2 Report[15], that analysis is flawed. As New Zealand and Australia are the only two closely integrated economies with imputation systems, there can be no need here to seek to follow international norms: decisions taken by the New Zealand and Australian governments regarding imputation will be the international norm.

Paragraphs 2.14 and 2.15 of the DD describe examples of such instruments in the trans-Tasman context, referring, in particular, to the Australian case of *Mills v Commissioner of Taxation*[16]. That case concerned the ability of an Australian bank to frank distributions to mainly Australian investors on certain notes issued by the bank's New Zealand branch. If there is any problem in such situations, it arises from the Australian domestic characterisation of certain instruments for income tax purposes and in the Australian treatment of a company's overseas branch income, rather than from New Zealand's provisions and treatment.

For instruments such as the PERLS V instruments described in the *Mills* case, we suggest it is not altogether appropriate to focus on the deductible nature of the interest on the notes in New Zealand and the New Zealand branch's income not being taxable in Australia as a self-contained or isolated stream of income. Clearly the Australian bank (CBA) had to have had, or received, Australian-taxed income in order to have franking credits available. The interest payments from the New Zealand branch were also, presumably, taxed in New Zealand by means of NRWT or the Approved Issuer Levy ("AIL").

Denial of imputation credits (Submission point 5A, page 32)

We oppose the introduction of legislation to deny the use of imputation credits to reduce tax on a dividend which is deductible to the payer.

Paragraph 5.6 of the DD considers the related situation where a hybrid instrument is issued by the foreign branch of a New Zealand company. It acknowledges that Example 2.1 would not apply because New Zealand would tax the branch income, but then continues by saying "*there seems no reason not to amend legislation to deny the use of imputation credits to reduce tax on a dividend which is deductible to the payer*." We oppose any proposal to introduce such a measure. Just because there does not seem to be any reason against doing something is not a valid or good enough reason to do that thing.

Taxation under other countries' CFC rules (paragraphs 5.26 – 5.27, page 36)

We submit that the primary rule should not apply to deny deduction where tax has been imposed in the hands of the payee's owners under a CFC regime.

The DD highlights, but does not express a view on the likely outcome, whether inclusion pursuant to a parent company's CFC rules should mean that the primary rule does not apply. Our view is that CFC inclusion higher up the chain should be treated as tax imposed in the same manner as if the hybrid arrangement were taxed in the direct counterparty.

Introducing an exemption where income is caught by a third territory's CFC rules would increase complexity. However, this complexity seems an unavoidable consequence of the removal of probable double taxation.

Regulatory capital (Submission point 5H, page 45)

We submit that New Zealand should exclude regulatory capital from any hybrid rules it implements.

Submission point 5H specifically requests comments regarding regulatory capital. There is little risk of regulatory capital for banks and insurers giving rise to BEPS issues and, accordingly, regulatory capital that conforms to the requirements of the particular regulator should be outside the scope of these proposals. The amount of capital that a particular entity requires is determined by the regulatory regime to which it is

[15]See Example 2.1 at page 280, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (OECD, October 2015)
[16] [2012] HCA 51

subject. The terms of regulatory capital securities that lead to hybridity follow regulatory requirements. Likewise, there are restrictions on how much of the minimum capital requirements can be made up of the different tiers of capital. The precise percentages applicable for a particular institution will be the subject of discussion between the regulator and the regulated entity. Regulatory oversight provides an objective measure of how much additional tier one and tier two capital a bank or insurer might be expected to need. We note that the United Kingdom, which has consulted widely on issues associated with regulatory capital, has not enacted restrictions in this area. The Australian Board of Taxation highlighted the complexities and interactions involved and recommended further work be undertaken on the issues. The Board has been granted an extension to examine this matter further, indicating that the matters involved are complex. Exemption could be achieved along the following lines:

- A specific definition of banking and insurance regulatory capital is introduced. That definition could be closely linked to the regulatory rules set by the parent company regulator, and

- Banking and insurance regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

A further aspect relating to banks which requires more careful and detailed consideration given the current NRWT and Approved Issuer Levy proposals in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill is the treatment of notional loans and payments between branches and cross-border head offices of the same legal entity and any disregarded payments rule (paragraphs 6.1 to 6.9 of the DD).

Commercial consequences of proposals

We submit that the commercial consequences of the proposals should be examined in more detail before final decisions are made.

The DD states that the proposals are not intended to disturb commercial or regulatory consequences.[17] It falls short of meeting that aim. Without limiting the scope of the rules to situations whereby the hybrid mismatch is artificial or contrived, there is significant risk of scope creep. Hybrids implemented for non-tax reasons will be caught by these rules notwithstanding the motives behind their design and implementation. Alternatively, such structures may be designed to utilise benefits explicitly allowed under New Zealand tax law.

In addition to the frankable/deductible structures already discussed, we are concerned by the inclusion of New Zealand family trusts (presumably complying trusts) within the potential category of reverse hybrids, at paragraph 7.2. Presumably there must be a limit on when the Hybrid Rules potentially apply to distributions to non-residents from New Zealand resident family trusts? It is common for children to receive distributions from such trusts while they travel overseas. The "temporarily absent" five-year rule in s HC 23 specifically covers this eventuality. It is possible that the allocation of overseas income by the New Zealand trust to the non-resident beneficiary may trigger the Hybrid Rules – which cannot have been intended. The present trust account and record keeping rules do not require the trustee to enquire into the tax treatment of that overseas income in the hands of the non-resident beneficiary. In any case, most New Zealand resident trustees would not have the capacity to make meaningful tax enquiries.

The reverse hybrid rule could also apply to foreign investor Portfolio Investment Entities ("PIEs"), to the extent the PIE derives foreign-sourced income which is allocated to foreign investors. Application of the rules in this situation will lead to uncertainty.

We also have concerns for the case of United States-parented groups introducing leverage down the chain. For example, where the United States entity sits above a "check the box" entity based in a low tax jurisdiction which provides funds to a disregarded New Zealand company. A tax benefit may result due to the differential between the New Zealand tax rate and that of the low tax jurisdiction, but we had understood that the intent was not to address benefits attributable to differences in tax rate rather than to the hybrid structure adopted.

[17] See paragraph 1.9 at page 7 and paragraph 4.6 at page 22.

Limits on foreign tax credits (Submission point 5A, page 32)

We submit that there should be some clarification around the existing concept of a "segment" of income for foreign tax credit purposes, to determine whether any further restriction is needed.

Paragraph 5.7 of the DD proposes amending the definition of a "segment" of foreign source income "*so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign source income*".

Before any such amendment is introduced, we suggest there should be some clarification around the existing concept of a "segment" of income for foreign tax credit purposes, to determine whether any further restriction is needed at all.

Section LJ 4 defines the phrase "segment of foreign-sourced income" for Subpart LJ (foreign tax credit) purposes as "*equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature*". We are uncertain of the meaning of "source" intended in this specific context, and of the intent of use of the alternative. For example, does it mean one can group interest payments from three different companies (sources) in the same country on the basis they are all income of one nature from the same country, or is it intended to treat interest payments from each company as a separate segment, on the basis they are from different sources (i.e., separate contractual instruments or arrangements)?

Proposal to tax intra-group dividends on hybrid financial instruments and ignore imputation credits attached (Submission point 5B, page 41)

We submit that the purpose of the proposed rule to ignore imputation credits when applying the secondary rule to hybrid dividends is unclear and that it should therefore not proceed.

Paragraphs 5.42 to 5.44 of the DD refer to situations set out in Example 1.23 of the Action 2 Report where New Zealand is Country B. The sort of situation envisaged would therefore appear to involve the New Zealand B Co 1 being an unlimited liability company which is treated by a US parent as a transparent entity under the US "check the box" rules. Presumably the loan from B Co 2 is legally a debt, in order for the US A Co to claim any interest deductions, although treated as equity under New Zealand's income tax rules.

It is not clear what the DD proposal is seeking to achieve (beyond, possibly additional tax payable in New Zealand if the payments continue to be regarded as dividends under New Zealand law but dividends which cannot have imputation credits attached) or what the justification really is. In itself, the New Zealand proposal would not seem likely to produce any global benefit or modify global behaviour in any useful way unless Country A changes its domestic rules to make the interest deduction contingent on New Zealand taxing an equivalent amount.

Timing mismatches (Submission point 5C, page 42)

We submit that timing differences should not be subject to the Hybrid Rules. In the event that submission is rejected, then greater thought should be given to the merits of the United Kingdom test and/or to lengthening the period over which timing mismatches are acceptable to longer than three years.

We recommend that the rules are targeted at permanent rather than timing differences. Given the proposed continued application of withholding tax, even where deductions are denied, and the current proposed widening of NRWT and restriction of AIL, the complexity involved with a timing mismatch rule outweighs the tax at stake. The DD does not appear to have considered how any timing mismatch measures will interact with the NRWT changes which are currently in the process of being enacted. As initially drafted, we are aware those proposals have attracted a number of submissions and objections, and it is not yet known whether or how they will be resolved. The addition of another layer of rules, this time potentially limiting deductions, would provide another layer of complexity and further compliance burden.
To demonstrate that complexity, issues associated with seeking to deny deductions to the extent they are not matched with income recognition in another country in the same period, include the need:

- For detailed knowledge of other country's income recognition rules.

- To obtain or hold confirmation or proof that the recipient has returned the income.
- To perform additional calculations to remove foreign exchange variation elements.
- To keep track of the fact and extent of any timing mismatches across a number of income years and from year to year.

In practice, should a timing mismatch rule be adopted, either the Australian three-year approach or the United Kingdom "reasonable period" approach are worth considering. The Australian approach is not automatically better. In some cases it will be more restrictive and will not reflect timing differences that arise under commercial arrangements. An example here may be a five-year finance lease with balloon repayment at the end of year five. For New Zealand, deductions would be spread under the financial arrangement rules but, in the United Kingdom, would be taxable at the end of year five under a specific statement of practice. Such an arrangement would likely lead to the denial of deductions under an Australian approach but cause no issues and remain deductible under the United Kingdom approach.

There also needs to be the ability to allow for correction of treatments as countries' time frames for implementation of the hybrids recommendations will vary, with some countries unlikely to adopt any or very few of the proposals and others likely to defer adoption for some years.

Transfer of assets: revenue account holders (Submission point 5F, page 44)

We submit that the transfer of assets should not be subject to the rules, therefore the question of an exemption for revenue account holders is not relevant.

Submission point 5F asks whether there should be an exemption from the Hybrid Rules for revenue account holders.

We query why New Zealand should introduce any Hybrid Rule at all that applies to straightforward asset transfer transactions. Just because different countries may characterise and tax such transfers differently does not seem to justify treating them as hybrid mismatches for which specific anti-mismatch rules should apply. Asking about possible exemptions therefore begs the main point at issue.

Applying Hybrid Rules to such transactions would seem to cut across a fundamental New Zealand domestic principle that capital/non-taxable and revenue/taxable characterisations may apply differently to each party to a transaction. It would counteract the application of the financial arrangement rules when there is a cross-border element, but not when a transaction occurs between New Zealand residents.

Paragraphs 5.52 to 5.55 of the DD refer to a New Zealand taxpayer who purchases an item from a non-resident under an agreement for sale and purchase where our domestic financial arrangement rules require the purchaser to treat part of the consideration as financial arrangement expenditure rather than as part of the cost of the item. Paragraph 5.52 seems to assume the non-resident vendor is not taxable on any part of the sale proceeds on any basis.

Incorporating a Hybrid Rule into New Zealand's law to reduce or prevent the purchaser from claiming any deduction, just because the vendor country's domestic laws do not apply an identical financial arrangement accrual approach and do not tax capital amounts, seems to cut right across New Zealand's general recognition that items can be acquired or disposed of on revenue account for one party while being held, sold or acquired as non-taxable, capital account items for the other transacting party. It is not clear why such differences should continue to be recognised in transactions between residents but not in cross-border transactions.

Paragraph 5.64 proposes that domestic transactions would be specifically excluded from application of the Hybrid Rules. As noted above, however, distinguishing between domestic and cross-border transactions would seem to introduce further inconsistencies and possible anomalies. We submit the real issue is whether or not there should be any Hybrid Rules relating to asset transfers.

Dual resident payers (Submission point 9A, page 67)

We submit that there should continue to be an objective test which taxpayers can apply in assessing dual residence under double tax agreements ("DTAs"), e.g., place of effective management.

Paragraph 4.33 of the DD refers to Chapter 13 of the Action 2 Report and a proposed change to Article 4(3) of the OECD Model Tax Convention. Under that change, dual residence issues for non-individual entities would be resolved on a case-by-case basis by the competent authorities of each DTA partner, rather than by taxpayers applying an objective and interpretative rule, such as the current place of effective management criterion.

Relying on competent authorities to determine residence under mutual agreement procedures on a case by case basis is not a satisfactory outcome. We doubt it would be practicable or cost-efficient for mutual agreement procedures to have to be invoked by any entity which may happen to be dual resident in terms of two countries' domestic laws. We submit New Zealand should not agree to or adopt such an approach.

Much more detailed consideration is required before proceeding with any domestic law change to a general rule that an entity is not a resident of a state if it is considered to be a resident of another state under a DTA.

Paragraphs 9.6 to 9.8 of the DD refer to another suggestion in Chapter 13 of the Action 2 Report, namely, that a country's domestic law include a general rule to the effect that an entity which is prima facie resident under the domestic law should be treated as non-resident for domestic law purposes if it is treated as resident of another state due to the operation of a DTA.

As acknowledged in Chapter 9 of the DD, New Zealand already has a number of domestic rules that ensure an entity which is resident of another country under a DTA cannot access certain (advantageous) features of New Zealand's tax system. There is no discussion in the DD, however, of other domestic implications which should also, presumably, follow from applying such a rule. For instance, we assume all non-New Zealand-sourced income derived by such an entity should cease to be taxable in New Zealand, while any dividends paid would presumably cease to have a New Zealand source.

We would also be concerned that defining dual residents in terms of a relevant DTA would lead to disputes and uncertainty.

Definitions

It is difficult to submit on key definitions in advance of seeing the scope of the proposals as included in draft legislation. However, there may be a case for excluding listed, widely held instruments from the definition of structured arrangement in order to reduce some of the transitional difficulties explained in Appendix A.

Appendix C - Design Principles

Interaction with withholding taxes

We submit that NRWT should not be charged on an interest payment for which deduction has been denied.

Paragraph 11.4 proposes that denial of a deduction for payment under any of the Hybrid Rules will not affect withholding tax due. This appears contrary to a coherent, fair tax system, worsened in situations were no DTA is in place to reduce the level of withholding tax payable to an associated person.

We suggest such an approach illustrates a conceptual difficulty with the Hybrid Rule proposals. The basis, in principle, for denying deductions under a Hybrid Rule is that the item is not taxed to the recipient. While the focus of the Action 2 Report approach may be the tax treatment in the recipient's country, we see no reason why taxation by the source country by means of withholding taxes or equivalent levies should be ignored. If recipients are not taxable in their own countries, they will presumably have to bear any such source country tax as a cost. As noted earlier, the Hybrid Rules are not intended to adjust for differentials in tax rates between countries and any limitations or zero-rates applying under a DTA presumably reflect the continuing conscious and deliberate choices made by contracting governments.

Hybrid rules and anti-avoidance

We submit that the proposals should not be subject to the general anti-avoidance rule ("GAAR") due to the level of uncertainty this will cause.

Paragraphs 11.15 and 11.16 of the DD propose that the rules would apply before, and be subject to, New Zealand's GAAR and that there should also be a specific anti-avoidance rule.

We submit such an approach will create excessive uncertainty for taxpayers and seems unnecessarily punitive. Recent cases have shown that the New Zealand Courts have been willing to apply the GAAR in relation to intra-group arrangements where the New Zealand tax base may not be being eroded by comparison with alternative funding arrangements which could have been used.

In the context of the two-tier approach of the Hybrid Rule proposals and their inherent contingency of application, the perpetual risk of the GAAR being applied to supersede the outcome of applying any domestic rules, including any domestic Hybrid Rules, in New Zealand must make it difficult, if not impossible, for the cross-border parties to be able to determine whether or how their own Hybrid Rules should apply in their own jurisdiction.

Given the Commissioner's recent approach to debt capitalisations in *QB 15/01: Income tax - tax avoidance and debt capitalisation*, we are also concerned that the Commissioner's default approach to any taxpayers moving to replace any current arrangements that would or may fall subject to any Hybrid Rule adjustments would be likely simply to invoke the GAAR.

We submit that is not appropriate from an overall perspective. If an aim of Hybrid Rules is to stop taxpayers using certain types of current arrangements or transacting in certain ways, then they should not be penalised in any event because they seek to change their current arrangements to those seen as acceptable in a cross-border context.

Legislative design proposals

We submit that the Hybrid Rule proposals should be contained in primary legislation rather than subsidiary regulation.

Paragraphs 11.17 to 11.19 of the DD suggest officials may be proposing to introduce only very general Hybrid Rules in terms of the primary legislation while allowing considerable detail and future changes to be dealt with by subsidiary regulation and giving powers to the Commissioner to override the rules in some circumstances.

We submit that approach is not appropriate and would be a fundamental change to the traditional approach to tax legislation in New Zealand. It seems likely to mask insufficient initial thought and articulation of what New Zealand is seeking to achieve in principle and in detail. Constitutionally there is no place for taxing rules if they cannot be expressed fully and properly for the legislature to consider. Unlike other counties (notably the United States and Australia), New Zealand has no history of delegated tax legislation by way of Inland Revenue regulations. With few exceptions (such as items that can be changed by Order in Council) New Zealand tax is imposed by statute only.

We also draw your attention to the criticism on similar grounds recently levied at the broad scope of an amendment to the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill[18] which proposes to allow transitional regulations and administrative exemptions to be made during Inland Revenue's business transformation process.

Information sharing and taxpayer secrecy

We submit that an amendment to the taxpayer secrecy provisions in s 81 of the Tax Administration Act 1994 will be required to enable Inland Revenue to release necessary information to counterparties.

The rules envisage much greater transparency of tax treatment, by both the taxpayer/s across jurisdictions and also by revenue authorities.19 Unless a specific exception to the taxpayer secrecy provisions is included, we fail to see how Inland Revenue will be able to communicate with counterparties. The exception to secrecy would need to cover information regarding matters relevant to determining the tax position taken by one party to a hybrid instrument or a hybrid payment, and how a hybrid entity treated a payment for tax purposes in New Zealand. We anticipate that equivalent rules would also be required in overseas jurisdictions.

Application of time bar

We submit that Inland Revenue needs to examine the interaction of the time bar provisions within s 108 of the Tax Administration Act 1994 with the proposals.

The DD does not mention how the time bar in s 108 of the Tax Administration Act 1994 might apply to payments that are subject to the Hybrid Rules. The time bar is to be extended to ancillary taxes including NRWT under the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill. But how will the time bar apply to deductions disallowed (under the primary rule) or payments received (under the defensive rule)?

With respect to the primary rule, the Commissioner will only be able to assess outside the usual time bar if returns containing deductions in respect of hybrid mismatches are, in the opinion of the Commissioner, "fraudulent or wilfully misleading", as there will be no "failure to mention income".20 Accordingly, it is presumed the time bar will apply after four years to hybrid payments (wrongly) deducted.

With respect to the defensive rule, we anticipate the Commissioner may look to apply the time bar to unreturned hybrid payments strictly. Failures to expressly mention receipts of such payments in returns or in any related financial statements or schedules may amount to failures to mention income of a particular type or from a particular source, in which case the time bar will provide no protection. We envisage increased dispute risk on time bar issues, particularly as to whether or not receipts which may be subject to the Hybrid Rules have been sufficiently "mentioned" in a return (or in related financial statements or schedules) for the time bar to apply.

[18] Supplementary Order Paper 190, introduced on 16 August 2016.
[19] For example, with respect to hybrid payments at paragraph 6.27, "Unlike the reversal approach, this option would require the payee country tax authority and payee jurisdiction taxpayers to be aware of the level of non-dual inclusion income being earned in the payer country." Again, for reverse hybrids at paragraph 7.32, "Recommendation 5.3 is that countries should have appropriate reporting and filing requirements for tax transparent entities established in their country. This involves the maintenance by such entities of accurate records of:

- the identity of the investors (including trust beneficiaries);
- how much of an investment each investor holds; and
- how much income and expenditure is allocated to each investor."

Paragraph 7.33 also states: "*Recommendation 5.3 states that this information should be made available on request to both investors and the tax administration*."

[20] See s 108(2) Tax Administration Act 1994.

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Addressing Hybrid Mismatch Arrangements – a Government Discussion Document

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Government discussion document *Addressing hybrid mismatch arrangements* (Discussion Document).

2. This submission is divided into two sections:

   a) Section A comments on a limited number of more general issues raised in Part I of the Discussion Document; and

   b) Section B comments on various submission points referred to in Part II of the Discussion Document.

3. All statutory references in this submission are to the Income Tax Act 2007 (the Act).

Section A: General issues raised in Part I of the Discussion Document

4. The Law Society accepts many of the proposals described in both the OECD's Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (Final Report) and the Discussion Document.

5. However, as indicated below, the Law Society is concerned that a number of the proposals contained in the Discussion Document risk placing undue burden on New Zealand taxpayers in furtherance of the global benefit sought to be achieved by them. The Law Society considers that while the adoption of the recommendations in the Final Report is in many cases appropriate (and possibly inevitable), care should be taken to ensure that New Zealand taxpayers are not unduly or unfairly impacted by the proposals.

Quantification of cost to New Zealand tax base

6. While the Law Society appreciates the notion that the Base Erosion and Profit Shifting (BEPS) initiatives are primarily designed from a global tax collection perspective, rather than with the implications for individual countries in mind, the Law Society nevertheless questions whether appropriate consideration has been given to the potential cost implications to New Zealand resulting from the proposed measures.

7. The Law Society would be interested to understand whether any analysis has been undertaken to project, for example:

    a) the anticipated increase in the collection of New Zealand tax as a result of the implementation of the proposals;

    b) the increased cost to New Zealand businesses in complying with the proposed measures; and

    c) the cost to New Zealand from the potential reduction in inbound investment resulting the proposed measures.

8. While the result of any such analysis would be only one factor in the decision to implement the hybrid proposals and would need to be balanced against the competing policy considerations detailed in Chapter 3 of the Discussion Document, there would be real benefit in attempting to understand and quantify the potential implications for New Zealand businesses. Without such analysis it is difficult to appropriately weigh the competing costs and benefits of implementation.

<u>New Zealand tax revenue loss caused by the use of hybrids</u>

9. The Law Society notes the comments made at paragraph 3.17 of the Discussion Document regarding the quantification of the New Zealand tax revenue loss caused by the use of hybrids:

> *"The New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown. However, the tax revenue at stake is significant in the cases that the Government is aware of, which shows a clear advantage to counteracting hybrid mismatch arrangements. <u>For example, the amount at issue under all funding arrangements comparable to the Alesco arrangement referred to in Chapter 2 was approximately $300 million (across multiple years).</u> In relation to hybrid entities, deductions claimed in New Zealand that are attributable to some prominent hybrid entity structures result in approximately $80 million less tax revenue for New Zealand per year."* [emphasis added]

10. The Law Society considers that this statement significantly overstates the potential cost to the New Zealand tax base from the use of hybrids.

11. Taking the *Alesco*-style optional convertible note arrangement referred to in the paragraph – the Discussion Document suggests that the cost to the New Zealand tax base of the deductions claimed by the various taxpayers under those optional convertible note instruments was (leaving to one side the successful application of the general anti-avoidance rules) the entire $300 million of deductions collectively claimed by those taxpayers. That significantly overstates the cost. Absent the convertible note arrangements, many of the relevant taxpayers are likely to have been funded into their New Zealand activities with interest bearing debt. It is also likely, given the nature of the "holder election" instruments entered into in those cases, that the interest on that debt funding would have been paid at a higher rate than that treated as having been incurred under the convertible notes. The

elimination of a deduction no inclusion (D/NI) outcome in these cases would, in all likelihood, have resulted in a cost to New Zealand.

New Zealand's tax sovereignty

12. The Law Society notes that in many respects the proposals contained in the Discussion Document compromise the implementation of rules and policies that New Zealand has previously determined to be the appropriate basis of taxation from a country standpoint, best serving its interests domestically and internationally.

13. This point can be demonstrated through the example contained at paragraphs 5.29 to 5.30 of the Discussion Document. Under that example, a New Zealand purchaser of assets pays a deferred purchase price giving rise to deductions for the purchaser under the financial arrangements rules. If no income is recognised in the vendor's home jurisdiction, the sale and purchase arrangement would give rise to a D/NI outcome, which in certain circumstances would result in the deduction being denied under the proposed linking rule.

14. New Zealand has determined that taxation on an accruals basis under the financial arrangements rules represents the most appropriate manner of taxing financial arrangements. That regime risks being seriously eroded through the application of the linking rule in the example given above.

15. The recommendations in relation to the deactivation of domestic transparency in Recommendation 5.2 of the Final Report provide a further and important example. The recommendation, if implemented, has the potential to upset basic principles of New Zealand taxation – in particular, the non-taxation of foreign-sourced income derived by non-residents. This could have a significant impact on New Zealand's desirability as a destination for investment and its financial and professional services industry. These basic principles should not be eroded without careful consideration of the potential cost to New Zealand.

16. The question is whether it is appropriate for New Zealand to compromise the operation of its rules and policies to effectively compensate for shortcomings in the global tax net, arising from the less comprehensive or poorly designed methods of taxation implemented in other tax jurisdictions.

17. That compromise may be difficult to avoid as a result of combating some hybrid mismatches, but care should be taken to limit the impact of the proposed rules on New Zealand's existing tax policy to the greatest extent possible.

Section B: Responses to submission points identified in Part II of the Discussion Document

Submission point 5A

Outline of proposal

18. As part of Recommendation 2 in the Final Report, the OECD recommends that countries amend their domestic tax rules to ensure that a dividend exemption is denied in respect of

deductible payments made under financial instruments. This recommendation has no limitation on its scope.

19. New Zealand already denies the foreign dividend exemption in respect of rights to a foreign equity distribution under section CW 9(2)(c). This section is proposed to be expanded to also deny the foreign dividend exemption in circumstances where a dividend is paid, and the payment of the dividend gives rise to a tax credit in the payer jurisdiction.

Comment and recommendation

20. The Law Society anticipates that this proposal will be difficult for many taxpayers to comply with. Because the proposed amendment to section CW 9(2)(c) would be of general application, it is likely that in many circumstances the recipient of the dividend will be unable to determine whether the company paying the dividend is entitled to a tax credit in its home jurisdiction.

21. The Law Society recommends that the proposed amendment to section CW 9(2)(c) be limited to apply only in circumstances where the recipient of the dividend has reason to believe that the company paying the dividend is entitled to a tax credit in its home jurisdiction in respect of that dividend payment. This (or similar) test could be supported by guidance from the IRD in relation to the circumstances in various jurisdictions which would be likely to result in the application of the proposed amendment to section CW 9(2)(c). There is no reason that the "reason to believe" (or similar) test could not also be applied to the current deductible dividend limitation of the foreign dividend exemption, in respect of which there must also be difficulties with compliance.

Submission point 5C

Outline of proposal

22. The Final Report confirms that the hybrid financial instrument rule should not generally apply to differences in timing between the recognition of payments under a financial instrument.

23. Accordingly, it is recommended that no D/NI outcome should arise if the tax administration can be satisfied that the payment under the instrument is expected to be included in income within a reasonable period following the deduction.

24. The Final Report states in paragraphs 55 - 60 that this concept should be triggered if:

a) the payment will be included by the payee in ordinary income in an accounting period that commences within 12 months of the end of the payer's accounting period; or

b) the tax administration is otherwise satisfied that the payee can be expected to include the payment in ordinary income "within a reasonable period of time".

25. The Discussion Document notes that an alternative approach has been advocated in the Australian Board of Taxation Report, under which an income recognition deferral of up to

three years would not attract operation of the hybrid rules.[1] Further, where a deduction is denied because of a deferral of more than three years before recognition, that deduction denial would be reversed upon the subsequent inclusion of the relevant income.

26. The Discussion Document seeks submissions on whether the Australian Board of Taxation approach in respect of timing mismatches under a hybrid financial instrument would be acceptable in New Zealand, or whether an alternative option (such as that proposed in the OECD's Final Report and implemented in the United Kingdom) would be preferable.

Comment and recommendation

27. The Law Society agrees with the comments made at paragraph 5.45 of the Discussion Document that an approach similar to that advocated by the Australian Board of Taxation, which operates based on the application of objective timeframes rather than a subjective "reasonableness" test, would be appropriate in respect of the New Zealand's self-assessment tax system.

28. The Law Society further considers a timing gap of three years to be reasonable in determining whether a timing mismatch has arisen which should be subject to the hybrid mismatch rules (before reversal on any subsequent inclusion).

29. The Law Society also submits that it would be appropriate to incorporate a de minimis threshold in respect of the quantum of the deduction before the rules could apply. For example, if after a three year period the deduction(s) claimed exceeds the recognition of income by more than, say, $50,000, the rules would apply. The introduction of such a de minimis threshold would ease taxpayer compliance costs for what is ultimately only a timing advantage.

30. The Law Society also supports the proposal to allow for a carry-forward of any deductions temporarily denied under this proposed rule. Because the only advantage obtained by a taxpayer under an arrangement subject to this rule is a timing advantage, it is appropriate to only counteract that timing advantage and not the deduction in its entirety.

<u>Submission points 5D and 6D</u>

Outline of proposal

31. The Discussion Document proposes to disregard controlled foreign company (CFC) taxation in respect of considering both:

    a) whether there is inclusion for the payee for the purposes of assessing whether a D/NI outcome arises in respect of Recommendation 1 (submission point 5D); and

    b) whether dual inclusion income arises for the purposes of preventing the application of the disregarded hybrid payments rule in Recommendation 3 (submission point 6D).

[1] http://taxboard.gov.au/files/2016/05/Implementation-of-the-OECD-hybrid-mismatch-rules.pdf

32. The reasons given at paragraph 5.47 of the Discussion Document for the proposal to disregard CFC taxation for the purposes of Recommendation 1 are that:

(i) it will sometimes be complex to establish the extent of CFC taxation;

(ii) there is no need to do so when applying the secondary response; and

(iii) taxpayers can use alternatives to hybrid instruments.

33. The reason given at paragraph 6.28 in relation to Recommendation 3 is that it will avoid drafting a large amount of very detailed and targeted legislation which is aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise.

Comment and recommendation

34. The Law Society opposes the proposal to disregard CFC taxation in the above circumstances.

35. The hybrid proposals should consist of a set of fair and principled rules to limit instances of non-taxation, rather than to impose penal double taxation. This point is commented on at paragraph 36 of the Final Report, where the OECD states that in respect of inclusion under a CFC regime:

> *"The hybrid financial instrument rule is only intended to operate where the payment gives rise to a mismatch in tax outcomes and is <u>not intended to give rise to economic double taxation</u>."* [emphasis added]

36. This point is again reiterated at paragraph 49 of the Final Report, which considers the nature and extent of the adjustment required under the hybrid financial instrument rule:

> *"The adjustment should be no more than is necessary to neutralise the instrument's hybrid effect and should <u>result in an outcome that is proportionate and that does not lead to double taxation</u>."* [emphasis added]

37. The Law Society does not find the reasons given at paragraphs 5.47 and 6.28 of the Discussion Document convincing. Ignoring CFC inclusion does not lead to a proportionate outcome. Each of the hybrid proposals will involve a complex set of rules which will be difficult to apply for taxpayers and the IRD alike. The complexity rationale would work against the implementation of any of the proposals. Similarly, the ability in many circumstances for a taxpayer to use alternative non-hybrid financing instruments does not justify the imposition of economic double taxation. If encouraging taxpayers to use alternative instruments is a key element of the non-inclusion, then a more appropriate and far less complex approach would be simply to prohibit the use of hybrids. As it stands, the proposals seek to counteract hybrid tax mismatches. It should be designed to do that successfully and not more.

38. If there are potential difficulties in establishing the extent of CFC taxation under some CFC regimes, the appropriate response would be for the relevant taxpayer to be subject to the burden of establishing that CFC taxation to the IRD. This is the approach adopted in the

OECD's Final Report, as summarised at paragraph 5.27 of the Discussion Document, and is the one that the Law Society considers should be adopted in New Zealand.

Submission point 5E

Outline of proposal

39. The Discussion Document outlines at paragraph 5.50 three possible approaches to address situations where a New Zealand resident holds an attributing interest in a foreign investment fund (FIF) which is subject to New Zealand tax under one of the fair dividend rate (FDR), cost, or deemed rate of return (DRR) methods.

40. Under current law a taxpayer applying one of these methods would be exempt from tax on any distributions received from the FIF. That would as a technical matter give rise to a D/NI outcome so as to potentially necessitate (if deductible in the payer jurisdiction) the denial of the deduction in the FIF country, or the inclusion of income in New Zealand.

41. In general terms, the three proposals outlined in the Discussion Document are to:

a) deny the FDR, cost and DRR methods to FIF interests on which deductible distributions would be made (Option A);

b) treat a deductible distribution as income of the New Zealand taxpayer in addition to any income recognised under the FDR, cost or DRR methods (Option B); or

c) treat a deductible distribution as income of the New Zealand taxpayer, to the extent that income has not already been recognised under the FDR, cost or DRR methods (Option C).

Comment and recommendation

42. In the Law Society's view, the order of preference of the above options is as follows (with the most preferable first): Option C, Option A, Option B.

43. Option C is the only option that would:

(i) prevent a D/NI outcome from arising so as to satisfy the hybrid mismatch objectives;

(ii) ensure that taxpayers are not subject to double taxation; and

(iii) allow impacted taxpayers the flexibility to continue to use the FDR, cost and DRR methods in respect of such investments.

44. Option B is the least preferable solution because it could result in economic double taxation for impacted taxpayers. As described above, the Law Society considers that the hybrid proposals should consist of a set of fair and principled rules which seek to limit instances of non-taxation and result in a proportionate outcome, rather than to impose penal double taxation on a taxpayer.

Submission point 7A

Outline of proposal

45. The reverse hybrid rule contained in Recommendation 4 of the Final Report seeks to neutralise D/NI outcomes arising from a payment made to a reverse hybrid. The proposal consists solely of a primary rule under which the payer jurisdiction will deny the deduction to the extent of the mismatch. The application of this rule is limited in scope to situations where the investor, reverse hybrid and payer are all members of the same control group, or there is a structured arrangement.

46. The Discussion Document seeks submission on whether there are any issues relating to implementing Recommendation 4 in New Zealand.

Comment and recommendation

47. The Discussion Document does not directly comment on whether inclusion as CFC income would be sufficient to prevent the application of a D/NI outcome from arising. However, given the comments detailed above in relation to the Discussion Document's treatment of CFC income in respect of Recommendations 1 and 3, it would appear likely that such income would be disregarded.

48. This outcome would be contrary to the statements made at paragraph 150 of the Final Report, which recommends that provided the taxpayer can establish such inclusion to the satisfaction of the tax authority:

> *"A payment that has been fully attributed to the ultimate parent of the group under a CFC regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the reverse hybrid rule."*

49. Consistent with the recommendation of the Final Report, and with the comments made above in respect of Recommendations 1 and 3, the Law Society submits that CFC inclusion should be treated as relevant for the purposes of implementing Recommendation 4 in New Zealand.

Submission point 7B

Outline of proposal

50. Recommendation 5.1 involves amendments to New Zealand's offshore investment regimes (the CFC and FIF regimes) to ensure that payments made to "reverse hybrids" which are fiscally transparent in the establishment country are subject to owner-level taxation in New Zealand.

51. By way of example, the Discussion Document anticipates that one method for counteracting such arrangements would involve an amendment to the CFC rules to provide that the owners of a CFC would be attributed with any income of the CFC to the extent that the establishment jurisdiction allocates that income to the owner for income tax purposes, and

that income is not subject to tax in that establishment jurisdiction as a result of that allocation (Option A).

52. The Discussion Document suggests two other solutions which have been adopted elsewhere:

a) the United Kingdom has adopted a narrower rule which would only include an amount as income of a United Kingdom investor to the extent to which a D/NI outcome arises having regard to the application of the hybrid rules in other jurisdictions (Option B); and

b) Australia already contains rules which seek to counteract mismatches arising from the use of reverse hybrids established in other countries, whereby a list of foreign entities is maintained that are treated as partnerships under Australian law to the extent to which they are fiscally transparent in their establishment jurisdiction (Option C).

Comment and recommendation

53. The Law Society considers that Options B or C would be more appropriate for adoption in New Zealand.

54. Option A has the potential for overreach, in that it might act to attribute CFC income to New Zealand investors in circumstances where the hybrid rules have already operated in another jurisdiction to prevent a D/NI outcome. That would contribute to a no deduction / income outcome. That outcome should not be risked if there are feasible alternative options (such as Options B and C).

<u>Submission point 7D</u>

Outline of proposal

55. Recommendation 5.2 in the Final Report encourages countries to implement domestic rules to deactivate tax transparency rules that achieve hybrid mismatches. The recommendation targets a situation where:

a) an entity is tax transparent under the laws of the establishment jurisdiction;

b) the person derives foreign source income or income that is not otherwise subject to taxation in the establishment jurisdiction; and

c) all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.

56. The Discussion Document confirms that in a New Zealand context, this could involve the taxation of the foreign-sourced income of partnerships and foreign trusts established in New Zealand where the income is allocated to an offshore investor within the same control group as the reverse hybrid, and the offshore investor treats the reverse hybrid as fiscally opaque.

57. In the case of foreign trusts, this rule would also potentially apply to require taxation in New Zealand where the income is treated as trustee income in New Zealand and is not taxed in any other jurisdiction.

Comment and recommendation

58. These proposals would involve New Zealand taxation of non-residents' foreign-sourced income. This is a fundamental change to long-standing tax policy.

59. Subsection BD 1(5) currently provides for the exclusion of non-residents' foreign-sourced income from the calculation of a person's assessable income. This is an outcome of New Zealand's right to tax being limited by the core principles of residence and source. In a trust context, section HC 26 operates to exempt foreign sourced income derived by a resident trustee where no settlor of the trust is resident in New Zealand (other than a transitional resident).

60. The June 2016 *Government Inquiry into Foreign Trust Disclosure Rules* (the Shewan Report) recently confirmed that the foreign settlor/resident trustee exemption represented sound tax policy. Paragraph 4.18 of the Shewan Report comments:

> *"The Inquiry considers that the current tax treatment of foreign trusts is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy."*

61. The Law Society considers that New Zealand should only adopt rules that abandon traditional limitations to taxation on the basis of residence and source as a last resort, and then in the most limited manner possible.

62. At least in relation to the use of New Zealand foreign trusts, the Shewan Report was satisfied that the introduction/enhancement of the various information reporting requirements for foreign trusts was sufficient to maintain New Zealand's international reputation without abandoning core principles of taxation. Perhaps similar disclosure rules in relation to New Zealand partnerships and other transparent entities would be sufficient to do the same without New Zealand taxing non-residents' foreign sourced income.

<u>Submission point 9A</u>

Outline of proposal

63. Recommendation 7 deals with situations where one entity is resident in two different countries, and is entitled to a deduction in each of those countries for a single payment.

64. The proposal is for both countries to deny the deduction to the extent that it is offset against non-dual inclusion income.

Comment and recommendation

65. Paragraph 9.3 of the Discussion Document acknowledges that where both residence countries have hybrid rules, it is possible for the disallowance of deductions under this recommendation to give rise to a double taxation outcome. However, the Discussion Document suggests that because in most cases dual residence status is deliberate rather than accidental, this outcome should be able to be avoided by taxpayers.

66. The Law Society makes two comments in relation to this approach.

67. First, it is incorrect to assume that, in most cases, dual residence status can easily be avoided or might be deliberately pursued by taxpayers. In many practitioners' experience, it is perceived by taxpayers as a risk to be managed because of the potential to create unwanted tax outcomes ranging from taxation in non-treaty jurisdictions to the denial of benefits similar to New Zealand's imputation regime (denied to dual resident entities).

68. A business operated cross-border can easily necessitate commercial units being established offshore. The autonomy of those units may range in practice depending on a number of factors: consumer preference; market size; local laws and customs; etc. In most cases, commercial (non-tax considerations) will dictate the level of presence and organisational control exercised in another jurisdiction.

69. The interaction of domestic tax residency rules that contain alternative tests for residency is not always clear and the risk of unintended dual residence is very real. This risk is heightened the more factually dependent the various tests are. The head office, centre of management and director control tests in section YD 2 are not straight-forward to apply in many cases and involve a factual inquiry with overlapping considerations. Each can involve a balancing of positive and contrary considerations in arriving at a view on application. The Law Society has not performed a review of the corporate tax residency rules in other jurisdictions. However, it is not difficult to imagine a range of different tests being applied to determine corporate residence status. The boundaries of the various tests in different jurisdictions based on anything but incorporation (or equivalent) can be expected to involve many of the same difficulties encountered in the application of our own tests for corporate tax residency. This all heightens the risk of unintended dual residence.

70. It is also possible that taxing authorities could reach inconsistent views on the application of similar tests following their own factual review and balancing other considerations.

71. Secondly, the Law Society submits that, regardless of whether dual residence status may be able to be avoided by taxpayers, the potential double taxation outcome envisaged by this proposal should not be pursued.

72. This proposal is another example of the rules deliberately imposing a double income penalty rather than simply addressing the tax result of hybridity. That approach risks overreach in a regime that addresses the outcome of hybrids as opposed to directly controlling their use.

73. The Law Society considers that the introduction of primary and defensive rules to ensure that the deduction is disallowed in only one of the countries in which the taxpayer is resident to be preferable to rules that risk double taxation.

Submission point 9B

Outline of proposal

74. At paragraphs 9.6 to 9.8 of the Discussion Document it is stated that the OECD Final Report encourages the adoption of a domestic law rule which deems an entity to not be resident for tax purposes if they are resident in another country through the operation of a double taxation agreement (DTA).

Comment and recommendation

75. The Law Society queries how in practice this proposal would interact with the proposed amendments to Article 4(3) of the OECD Model Tax Convention (discussed at paragraph 4.33 of the Discussion Document) which would provide that the tiebreaker mechanism for residence in a DTA will be resolved by the competent authorities of each DTA partner rather than through an interpretive rule as to the place of effective management.

76. The Law Society recommends that consideration be given to either (or both):

a) publishing guidelines to ensure that taxpayers will be aware of the types of circumstances which would be likely to result in them being deemed to be resident in New Zealand for DTA purposes through this competent authority mechanism;

b) a streamlined competent authority process so that taxpayers can obtain clarity upfront and in a timely way as to their residence status for tax purposes.

77. If taxpayers would lose their New Zealand tax residence status as a result of a decision of the competent authorities, taxpayers should be informed of the circumstances which would lead to such a decision, and should not be left in doubt for any significant period awaiting such a decision.

Submission point 10

Outline of proposal

78. Recommendation 8 deals with imported mismatches which arise when:

a) a payment is made to a recipient in a country that does not have hybrid mismatch rules;

b) that particular payment does not give rise to a hybrid mismatch; but

c) the recipient of that payment enters into a hybrid mismatch arrangement with a third party in another jurisdiction.

79. The proposal is that where the imported mismatch rule applies (i.e. within a control group or as part of a structured arrangement) a deduction for the original payment would be denied even though it does not give rise to a hybrid mismatch itself.

Comment and recommendation

80. The Law Society submits that the imported mismatch rule is likely to give rise to significant compliance costs concerns for New Zealand taxpayers in circumstances where the mischief arises entirely outside New Zealand, and the likely revenue collection will be minimal.

81. Requiring New Zealand taxpayers to consider the tax treatment in two other jurisdictions before claiming a deduction is unduly onerous.

82. If the imported mismatch rule is to be introduced in New Zealand, the Law Society submits that as indicated at paragraph 10.11 of the Discussion Document, adequate de minimis and safe harbour thresholds be introduced. It would make sense for New Zealand to set these de minimis and safe harbour thresholds at the same or similar levels to those decided upon in Australia, to ensure consistency across the two jurisdictions for subsidiaries in multinational groups which operate in both New Zealand and Australia.

<u>Submission point 11A</u>

Outline of proposal

83. At paragraph 5.10 of the Discussion Document it is suggested that the imposition of withholding tax on a payment is not full taxation as ordinary income (with the resulting implication that a deductible payment which is subject to withholding tax in the payer jurisdiction will be treated as a D/NI outcome, with that payment being deemed to be non-deductible).

84. At paragraph 11.4 of the Discussion Document it is then suggested that where a deduction is denied under the hybrid rules, this would not affect the underlying withholding tax treatment on that payment.

Comment and recommendation

85. The combined effect of these two statements will result in an overreach of the hybrid proposals. If the deduction on the payment which produces the D/NI outcome is denied in its entirety, but is still subject to withholding tax under the NRWT rules, the operation of the hybrid rules will result in an asymmetrical partial inclusion/no deduction outcome.

86. This is entirely inconsistent with the tenor of the NRWT proposals contained in the recent May 2016 *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill*. One of those proposals was to broaden the NRWT rules to apply in circumstances where a borrower that is an associated person of the lender incurs deductible financial arrangement expenditure.

87. As described at paragraph 2.21 of the May 2015 *NRWT: related party and branch lending* issues paper, that proposal was one of a number of changes intended to ensure symmetry between the tax treatment under the financial arrangements rules (under which a deduction

to the payer was allowed) and the NRWT rules (which previously did not impose a withholding obligation on financial arrangements rules expenditure):

> *"The suggested changes in this issues paper are aimed at helping ensure a more appropriate amount of tax is paid by non-residents on their New Zealand sourced income, thus better aligning taxation with real economic activity and reducing current asymmetries."*

88. It appears inconsistent to advocate for the need for alignment between deductibility and the imposition of NRWT in support of the proposal to broaden the scope of the NRWT rules on one hand, but on the other to suggest that alignment is unnecessary where a deduction is denied to the payer under the hybrid proposals.

89. The Law Society submits that the principle of alignment between the NRWT rules and the financial arrangements rules should be respected under the hybrid proposals as well as the proposal to increase the scope of the NRWT rules. This could be achieved by either:

    a) only partially denying a deduction under the hybrid rules in respect of a deductible payment that is subject to NRWT, but does not produce income in the country of the recipient, reflecting that there is not a full D/NI outcome; or

    b) (more simply) relieving a payment from the imposition of NRWT where a deduction on that payment has been denied under the hybrid proposals.

<u>Submission point 11D</u>

Outline of proposal

90. At paragraphs 11.17 to 11.19 the Discussion Document considers the merit of legislating in broad principles which could be "fleshed out" by regulations of some kind.

Comment and recommendation

91. The Law Society submits that, to the greatest extent possible, the detail of the hybrid mismatch rules should be expressed in the Act rather than in regulations.

92. While regulations may provide a more flexible option which would allow for the rules to be more easily amended over time, there is a risk that:

    a) flexibility in amendment may compromise taxpayer certainty; and

    b) amendments would be made without full consultation.

<u>Submission point 11E</u>

Outline of proposal

93. The Discussion Document puts forward the view that because the impact of the hybrid mismatch proposals will in most cases be able to be established now by reference to the OECD's Final Report, there is no need to introduce any grandfathering provisions.

94. Instead, the new hybrid mismatch rules would apply to payments made after a taxpayer's first balance date following enactment. Taxpayers are considered to have enough time between the introduction of the relevant legislation and its enactment to restructure any arrangements which might be impacted by the proposal.

Comment and recommendation

95. The Law Society submits that taxpayers should be afforded a reasonable period of time to consider any hybrid mismatch legislation in its final form, and to implement any restructuring arrangements prior to the effective date.

96. Whether the proposed timeframe set out in the Discussion Document would in practice afford taxpayers such time will be likely to be determined by the period of time it takes from introduction to enactment, and the significance of any changes to the draft legislation produced at introduction.

Conclusion

97. This submission has been prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

Kathryn Beck
President

BCL

11th November 2016

#019

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir or Madam,

Submission on Addressing hybrid mismatch arrangements

We thank you for the additional time granted to submit on this topic.

The focus of our submission is Submission point 7D relating to the OECD's Recommendation 5.2.

We disagree with the suggestion made in paragraphs 7.28 and 7.29 of the discussion document that trust classifieds as foreign trusts under part HC of the Income Tax Act 2007 represent "reverse hybrids". Accordingly, applying the OECD's Recommendation 5.2 the discussion document suggests foreign trusts should become taxable on their non-New Zealand sourced income "*to the extent that that income is not taxed in any other country*" (Paragraph 7.29).

We consider this proposal is based on an incorrect assumption that the Income Tax Act 2007 ("the Act") attributes trust income to the settlor (so therefore a trust has look through tax treatment and is fiscally transparent).

The Act treats a trust as a separate person for income tax purposes, and not as a fiscally transparent entity similar to a look-through company or the United States "Grantor Trust" regime. Under sections HC 6 and HC 7 of the Act, income derived by a trustee of trust may be distributed to a beneficiary in which case it is effectively treated as a deduction for the trustees. If no allocation is made, then the income is treated as that of the trustees. This is not the characteristic of a fiscally transparent entity. The trust is not a fiscally transparent entity but fiscally opaque. On that basis a foreign trust could not be a reverse hybrid and Recommendation 5.2 should not apply.

We are also concerned that this proposal is contrary to current tax policy regarding the taxation of non-New Zealand sourced income derived by non-residents. Section BD 1(5) of the Act excludes such income from the definition of assessable income. With regard to trusts, section HC 26 treats foreign-sourced income derived by a New Zealand resident trustee as exempt income where no settlor of the trust is tax resident in New Zealand (other than a transitional resident).

Furthermore we note paragraph 4.18 of the recent *Government Inquiry into Foreign Trust Disclosure Rules* undertaken by Mr John Shewan commented:

> *"The Inquiry considers that the current tax treatment of foreign trusts is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy."*

Mr Shewan's Inquiry had a very wide-ranging brief and given his endorsement of the current tax policy, we see no basis for what would be a dramatic change of established tax policy particularly as it appears to be based on a misunderstanding of how the Act currently regards a trust.

We would be pleased to discuss any of the issues raised in this submission with officials.

Yours faithfully,
BAUCHER CONSULTING LIMITED

Terry Baucher

Terry Baucher LLB M.ATAINZ TEP
Director

#020

NEW ZEALAND NEEDS A TAILORED APPROACH TO THE OECD'S PROPOSALS TO NEUTRALISE SO-CALLED "HYBRID MISMATCH ARRANGEMENTS"

David Patterson / Peter North

SUMMARY

1 This paper advocates for New Zealand to take a "tailored" approach to the "OECD Hybrid Report" [1] proposals. Under this tailored approach:

- NZ should reject any presumption that, without the need for further thought, the UK "General Principle Overlay Approach" should be adopted;

- NZ should make deliberate policy decisions in NZ's interest as regards each of the OECD policy recommendations and the extent to which each is adopted by NZ. To the extent the OECD proposals are to be adopted, specific new rules should be integrated into the existing statute (not served up as a stand-alone overriding subpart of the statute);

- some of the OECD Hybrid Report proposals should not be adopted at this time. At this stage our view is that rules that deny to foreign direct investors NZ interest deductions which would otherwise be allowed within NZ's existing framework should not be adopted. Such rules include the imported mismatch rule, the rule as regards disregarded payments by hybrid entities and the rule as regards payments made to a reverse hybrid.

2 The compelling reason for the suggested tailored approach is that adoption of the UK General Principle Overlay Approach, without further thought, would potentially have a significant adverse impact on the NZ Government's current policy emphasis on attracting more foreign direct investment into NZ.

3 There are a range of other reasons supporting the tailored approach: that hybrid mismatch issues are not a significant threat to the NZ tax base; that the full OECD Hybrid Report proposals are mind-boggling in their complexity (and NZ is not a "rhinoceros", see below); and that there are significant flaws in the foundations of the OECD Hybrid Report proposals. But in our view the Government's own policy as regards attracting FDI compels the tailored approach.

THE OECD PROPOSALS

4 The OECD Hybrid Report contains strong recommendations for major international tax changes requested to be delivered broadly by concerted domestic law tax changes by member countries.

5 The concern broadly addressed by the OECD Hybrid Report is double non-taxation, i.e. non-taxation (or low taxation) in both the source country of income and the country of residence of the investor. The report broadly targets hybrid mismatch arrangements that exploit a difference in tax treatment of an instrument or an entity

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1 OECD *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, (2015) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

under the laws of two or more countries which lowers the total tax costs to the parties to the arrangement.[2]

6 More specifically, the OECD Hybrid Report contains 8 recommendations for changes to the domestic law of member countries and a smaller group of recommendations for changes to the tax treaties. This paper focusses on the recommended domestic law changes. The outcomes sought to be counteracted by the OECD are broadly:

- **Deduction no inclusion outcomes ("*D/NI*"):** Payments giving tax deductions under the rules of the payer country and are not included in the ordinary income of the payee. The OECD proposed rules broadly target D/NI outcomes as a result of:

  (a) "hybrid instruments"; and

  (b) "hybrid entities".

- **Double deduction outcomes ("*DD*"):** Payments that give rise to deductions in two or more countries for the same payment resulting from hybrid entities or dual residents;

- **Indirect deduction/no inclusion ("*Indirect D/NI*"):** Payments that are deductible under the rules of the payer country and are set-off by the payee against a deduction under a hybrid mismatch arrangement. This is covered in rules directed at "imported mismatch arrangements".

Recommended rules to address D/NI outcomes

7 More specifically, but still at the helicopter level, we outline below the targets of the OECD's recommendations as regards D/NI outcomes. Yes, unfortunately even for a reasonably high level paper addressing NZ's policy response at a high level, we need to start by having some understanding of the detailed subject matter. Without that, no sensible conclusions can be drawn as to the best overall approach.

Hybrid Instruments

8 These are circumstances where a D/NI outcome is the result of:

- the terms of the financial instrument (broadly the payer country allows a tax deduction and the payee does not include income, for example because one country treats the payment as deductible interest and the other treats the payment as a tax-exempt dividend). See Examples 1 and 3 in the Appendix; or

- a hybrid transfer, by which is meant broadly a transfer of a financial instrument on terms where a mismatch arises because, following the transfer, one country treats the transferee as the owner of the financial instrument and another country treats the transferor as the owner of the same financial instrument. Sale and repurchase ("*repo*") agreements are an example; or

- substitution payments, by which are meant broadly payments under a transfer of a financial instrument which involves the making of payments

2 OECD *Neutralising the Effects of Hybrid Mismatch Arrangements*, (2014) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, at paragraph 41.

between the counterparties in substitution for the underlying return on the financial instrument. Securities lending arrangements are an example.

9 Hybrid instruments are covered in Recommendation 1 of the OECD Hybrids Report. The suggested primary response is for the payer country to deny the deduction for the payment to the extent that it gives rise to a D/NI outcome. A secondary "defensive" rule is also recommended: if the payer country does not act to deny the deduction, the payee country should in its domestic law require the payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

10 There then follow clarifications/exceptions, including that:

- the rule only applies to payments between "related persons" (generally 25% direct or indirect common ownership between the payer and payee) or pursuant to a "structured arrangement";
- the rule does not apply to mismatches solely attributable to the status of the taxpayer or the circumstances in which the instrument is held;
- the rule does not apply to timing differences provided that the income arises within a "reasonable period of time";
- the rule does not apply to certain investment vehicles;
- "payments" do not include "payments that are only deemed to be made for tax purposes and that do not involve the creation of rights between parties" (consequently, OECD's recommendations do not target accounting entries such as debt forgiveness or foreign exchange fluctuations for example, as debt forgiveness is not a "payment" made and foreign exchange differences are said only to reflect the nominal values assigned by jurisdictions to a payment rather than constituting payments in and of themselves[3]).

11 This rule is reinforced by Recommendation 2 which specifically requires that a payee country should not grant a dividend exemption for dividend payments that are treated as deductible by the payer. NZ law already provides for this outcome – see sections CW 9(2)(b) and (c) of the Income Tax Act 2007. Recommendation 2 also extends to restrict dual claiming of foreign tax credits for withholding tax at source under "hybrid transfers" (see above) where two countries see different persons as the tax owner of a transferred financial instrument.

Hybrid Entities

12 The disregarded hybrid entities rule in Recommendation 3 will most commonly apply where the payer entity is treated as opaque (a separate entity) by the payer country and transparent by the payee country. This rule targets a D/NI outcome that arises from a disregarded payment, which is a payment: deductible under the laws of the payer country; and that is not recognised under the laws of the payee country by reason of the tax treatment of the payer under the payee country's laws (i.e., generally, where the payee country treats the payer as transparent).

13 The suggested response is for the payer country to deny the deduction for the payment to the extent that it gives rise to a D/NI outcome. A secondary "defensive"

3 See analysis in OECD Hybrid Report at examples 1.17 and 1.20.

rule is also recommended: if the payer country does not act to deny the deduction, the payee country should in its domestic law require the payment to be included in ordinary income of the payee to the extent the payment gives rise to a D/NI outcome.

14 Again and similar to Recommendation 2, there are clarifications and exceptions, including that:

- the rule does not apply to the extent the deduction to the payer in the payer country is set-off against income that is included in income under the laws of both the payee and the payer countries (i.e., "dual inclusion income"), with any deduction in excess of the dual inclusion income being quarantined and offset against dual inclusion income in a future period;

- the rule applies only to parties in the same "control group" (generally 50% or greater direct or indirect common ownership) or for parties to a "structured arrangement";

- the rule can apply to current expenditure such as interest, service payments, rents and royalties. But it does not apply to the cost of acquiring a capital asset or depreciation allowances.

15 Recommendation 4 addresses D/NI outcomes from payments to "reverse hybrids". A "reverse hybrid" is any person that is treated as a separate entity by an 'investor country' (i.e., the country of residence of investor) and transparent in the 'establishment country' (i.e., where the entity is established). Reverse hybrids will most commonly involve payments from a 'third country' (i.e., where the payer is located) to the payee (the reverse hybrid and in which the investor invests) that is transparent in the payee country, but treated as a separate entity by the investor under the investor country's tax law. See Example 2 in the Appendix.

16 The suggested response in Recommendation 4 is for the payer country (i.e., the country from which the payer makes the payment <u>to</u> the reverse hybrid) to deny the deduction to the extent the payment gives rise to a D/NI outcome.

17 The clarifications/exceptions to the Recommendation 4 rule are that:

- the rule only applies where the investor/the reverse hybrid and the payer are members of the same control group (generally 50% or more common control) or if the payment is under a "structured arrangement" to which the payer is a party; and

- the rule only applies if the D/NI outcome would not have arisen if the payment was made direct by the payer to the investor.

18 Recommendation 5 recommends further countering reverse hybrids by: investor countries tightening their CFC rules to prevent D/NI outcomes for payments of reverse hybrids; and if the investor country does not act, the establishment country of the reverse hybrid bringing the reverse hybrid income into its tax net.

19 Recommendation 8 introduces the 'imported mismatch rule' to address D/NI outcomes which occur in multiple jurisdictions other than the payer country, but due to a lack of anti-hybrid rules are not addressed by those countries, and accordingly, are effectively 'imported' into the payer country. The suggested response in

Recommendation 8 is for the payer country to deny a deduction to the extent the payment from the payer country produces an indirect D/NI outcome under the rules of the payee country and another country. See Example 4 in the Appendix.

20 The clarifications/exceptions to this rule are that the payer, the payee and the other party must be within the same control group or the payment by the payee is under a "structured arrangement" to which the payer is a party.

21 This rule is hideously complex/ highly controversial and is addressed further below in the context of its potential negative impact on NZ's attraction of FDI. As noted in the OECD Hybrid Report, the imported mismatch rule would not be necessary with universal adoption of the other anti-hybrid recommendations, as the mismatch occurring between a payee country and another country would already be counteracted. See example 4 in the Appendix.

Recommended rules to address DD outcomes

22 Recommendation 6 addresses DD outcomes (deductions in two or more countries for the same payment) that are the result of an entity being a "hybrid payer". A hybrid payer broadly arises when:

- a company has a branch and a deduction is allowed for a payment both in the country where the branch is established and in the country where the company is formed; and
- an entity resident in a payer country is allowed a deduction for a payment in the payer country but a deduction is also allowed to the investor (or a related person) in the entity because the entity is treated as transparent under the law of the investor country.

(The rule is stated more broadly, but these are the two primary examples.)

23 The suggested response is that the establishment country of the company with the branch/the investor country should deny the duplicate deduction to the extent it gives rise to a DD outcome. If that country does not act, a defensive rule is suggested under which the branch country/payer country should deny the deductions.

24 Clarifications/exceptions include that: the defensive rule only applies if the parties are in the same control group or the DD outcome arises under a "structured arrangement" and the branch/the payer are parties; the rule does not apply to the extent the deduction is set-off against dual inclusion income (to the extent exceeding current dual inclusion income, the deduction may be quarantined and offset against future dual inclusion income); the rule can apply to current expenditure, but does not apply to the cost of acquiring a capital asset or depreciation allowances.

25 Recommendation 7 counters DD outcomes for payments by a taxpayer that is a dual resident (i.e., where a taxpayer is a tax resident of 2 countries). Both countries are to deny the deduction for the payment to the extent it gives rise to a DD outcome. The rule does not apply to the extent that the deduction for the payment is setoff against dual inclusion income (excess deductions over the amount of dual inclusion income in a current year can be carried forward to set off against dual inclusion income in a future period).

INLAND REVENUE'S 2016 POLICY DISCUSSION DOCUMENT

26 The IRD Discussion Document[4] largely begins with the premise that the OECD rationale for the hybrid mismatch rules is appropriate.[5] The IRD suggestion is that:

- NZ should largely, without further thought as to the wisdom of the policy from NZ's perspective, adopt the full set of propositions put forward in the OECD Hybrid Report; and

- NZ's adoption should be comprehensive, rather than specifically targeted at known mismatch arrangements affecting NZ.

27 For reasons outlined below, this paper suggests that NZ should reject IRD's proposed approach and should in contrast consider carefully the approach to be taken and:

- be far more restricted in the degree to which the OECD Hybrid Report's proposals are adopted; and

- for those proposals that NZ does adopt, the law change should be integrated within the NZ current law, and not be a standalone subpart of the statute purporting to override the remainder of the statute.

28 Some small attempt is made in the IRD Discussion Document to suggest the possibility of NZ revenue loss from hybrid mismatch arrangements.[6] A suggestion is made that the *Alesco*[7] arrangements cost NZ approximately NZ$300 million in tax and that hybrid entity structures (presumably the reference includes Australian Limited Partnerships structures) result in approximately NZ$80 million NZ tax lost per year. We will address this in more detail below, but the *Alesco* arrangements almost certainly would have cost NZ no income tax. The NZ$80 million assessment of NZ tax loss on offshore hybrid entity structures (such as Australian limited partnerships) may indeed be accurate. What that suggests though is a small targeted adjustment to NZ's tax laws—it does not in any sense justify adoption of the full array of changes suggested by the OECD.

29 The IRD Discussion Document at paragraph 3.21 purports to show an example of pure economic loss for NZ from a hybrid financial instrument. But the loss identified in that example has already been counteracted and does not arise under the current law by virtue of section CW 9.

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4 Policy and Strategy at NZ Inland Revenue *Addressing Hybrid Mismatch Arrangements, a Government Discussion Document* (September 2015). ("*IRD Discussion Document*")

5 IRD Discussion Document, paragraphs 3.1 to 3.27. Of the 83 page document, 6 pages are devoted to the policy framework issues.

6 IRD Discussion Document, paragraphs 3.17 to 3.21.

7 *Alesco New Zealand Limited v Commissioner of Inland Revenue* (2013) 26 NZTC 21,003.

TWO POSSIBLE APPROACHES TO ANTI-HYBRID MISMATCH RULES: UK "GENERAL PRINCIPLE OVERLAY" OR A "TAILORED" APPROACH

UK "General Principle Overlay Approach"

30 What we describe as the UK "General Principle Overlay Approach" involves the UK's enactment of a separate standalone part (Part 6A) in TIOPA 2010[8] which largely seems to operate to override the tax consequences that would otherwise arise under the UK tax statutes in the absence of the new Part 6A. Part 6A extends to 68 pages of legislation and is expressed in broad terms along the lines of the principles in the OECD Hybrid Report. In Australia the ATO also seems to support a set of self-contained provisions along the lines of the OECD Hybrid Report. There is an ease to this approach from a perspective of IRD officials:

- little further thought need be given to the rational for the OECD's recommended changes;
- if anything, the legislation enacted will overshoot rather than undershoot the objectives and may result in double tax;
- problems and difficulties in interpreting the law are left for taxpayers to grapple with, and subsequent legislative corrections can be made where essential; and
- NZ can with ease tick the box as regards the OECD's recommendations and automatically be a fully compliant member of the country club.

Tailored Approach

31 The other approach, which we recommend, is for NZ to tailor its response and, to the extent the OECD's recommendations are adopted by NZ, NZ should deliberately integrate its response into the existing laws. Under this approach:

- NZ is required to make deliberate policy decisions as regards each of the OECD's policy recommendations. For each proposal the Government/Parliament will need to resolve the extent to which it should be enacted by NZ and how best to enact it and fit it into the current legislation; and
- the changes that are made are more likely from the outset to work as intended and be integrated into the NZ Income Tax Act in a way that is capable of understanding by a majority of taxpayers and their advisers.

NZ an early adopter or late adopter?

32 The tailored approach that we suggest is necessarily a tactical response by NZ to the OECD's recommendations that sees NZ able to show that it has "in essence" adopted to a considerable degree the changes suggested by the OECD, while at the same time ensuring that NZ's best interests are served and that NZ's tax system retains its integrity and simplicity as far as is possible. As a tactical response (rather than a tick the box adoption), we suggest NZ be a late adopter, rather than an early

[8] Taxation (International and Other Provisions) Act 2010 (UK).

adopter of these changes. Having regard to the approaches taken in countries that are NZ's major investment and trading partners will help NZ measure its response.

WHY NZ NEEDS TO TAKE THE "TAILORED" APPROACH

Context: Hybrid Mismatch issues are not a significant threat to the NZ tax base; a tailored response is sufficient

33 For proposed tax reform of this scale, it is elementary that the proposed tax reform is able to be justified by an identified threat or identified upside for the NZ tax base. Somewhat alarming is that the IRD Discussion Document does not even seek to identify a NZ tax base issue that justifies implementing proposed hybrid mismatch reforms on the scale suggested (see above).

34 Moreover, experience over the last 20 years makes it clear that there is in fact no NZ tax base upside/NZ tax base concern that justifies the proposed hybrid mismatch reforms. Over the last 20 years the only items we have seen that raise NZ tax base issues of the type addressed by the proposed hybrid mismatch reforms are set out below. Further, as we outline below, those issues are capable of being remedied or have been remedied, by tailored legislation/IRD determinations. So in our view it is clear that NZ tax base protection does not warrant an intrusion of anywhere near the scale suggested by the proposed hybrid mismatch reforms:

- ***NZ's Conduit Regime***: This was a significant NZ tax base issue resulting from a flawed legislative enactment:

  (a) The intention of the conduit regime was to relieve tax on CFC income and offshore dividends for NZ holding companies with offshore operating subsidiaries to the extent of non-resident ownership of the NZ holding company. The aim was to reduce the number of NZ holding companies moving offshore as they expanded by raising capital from non-NZ residents, as a result of NZ's overly aggressive CFC regime at that time relative to those of all other countries in the world;

  (b) One effect of the regime in the way it was enacted was that NZ's banks (mainly Australian owned) were literally allowed to reduce their tax liabilities by borrowing and investing in offshore preference shares issued by offshore financial institutions. This was also allowed to occur in circumstances where tax deductions were available to the offshore financial institutions in the UK/US in relation to the tax-exempt returns they paid to the NZ banks. IRD originally asserted that the reduction in NZ bank tax was intended as a policy matter. Some favourable IRD binding rulings were also issued. Billions of dollars of transactions were undertaken and a number of years later the IRD decided to challenge the transactions under the anti-avoidance regime and IRD succeeded in two High Court judgments (*Westpac*[9] and *BNZ*[10]). The cases were settled before appeals were heard. NZ changed tack, softened the CFC regime with an active business exemption, and the conduit regime was repealed. The issue was removed by tailored legislation;

[9] *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834.

[10] *BNZ Investments Limited & Ors v Commissioner of Inland Revenue* (2009) 24, NZTC 23,582.

- ***OCNs***: In recent years a number of NZ subsidiaries have raised capital by issuing optional convertible notes (option for the holder to convert the note into the subsidiary's equity) ("*OCNs*") to offshore parent companies (or associates). Under NZ's financial arrangement rules the OCNs could be on terms that they were interest free and the IRD's promulgated determinations under the financial arrangements rules allowed for notional interest deductions for the NZ subsidiaries. This occurred without any NZ withholding tax, as the financial arrangements rules did not apply to most non-residents. IRD recently succeeded in an anti-avoidance challenge for the notional interest deductions in *Alesco*, even though it is unlikely that in reality this was a NZ tax base issue; if investment had not been by OCN, similar tax deductions in NZ would have been available by a straight debt investment by the foreign parent company. In addition, in certain foreign jurisdictions, Australia being one, the tax laws did not require inclusion of income. Again this was arguably a flawed regime from a NZ tax perspective and has been amended by tailored amendment to the IRD determinations (new Determination G22A creates no phantom interest deductions in wholly-owned group contexts or where OCNs are held pro rata to equity);

- ***MCNs***: Investments by offshore parent companies/shareholders have also been made by way of mandatory convertible notes ("*MCNs*") into NZ subsidiaries. Again, NZ IRD determinations have allowed interest deductions for interest payments on the MCNs even to offshore parent companies or shareholders holding the MCNs proportionate to their equity investment. A number of offshore regimes (including Australia) have treated the MCNs as equity and allowed exemptions for the interest as exempt dividend income. Again, it is unlikely that there has been in reality a NZ tax base issue with these instruments; given, if not by way of MCN, NZ would have allowed interest deductions to the NZ company for interest expense incurred on straight debt financing. IRD has raised a number of tax avoidance cases involving MCNs, at least one of which has been settled by the taxpayer paying significant amounts.[11] Tailored amendment to the IRD Determinations could address this issue if it was viewed as problematic from a tax base perspective (see current Determination G5C);

- ***Perpetual Debt***: Certain jurisdictions treat perpetual subordinated debt as equity. This allows also for a similar type of arbitrage where NZ allows interest deductions and the investor country may choose to allow tax exempt dividends or foreign tax credited dividend treatment. Other mismatches may rise around debt/equity treatment, i.e. two further examples involve debt issued in substitution/proportion to equity (section FA 2(5), now repealed) and profit-related debentures (section FA 2). These last two are situations where NZ confers/has conferred equity treatment and a foreign country may treat an instrument as debt. Again, these have generally not caused NZ tax base issues because of the operation of section CW 9 (if the foreign country allows a deduction, NZ does not allow the tax-exempt dividend treatment).

- ***Bank regulatory capital***: It has been reasonably common practice for Australian banks with NZ subsidiaries to raise regulatory capital in ways that achieve tax deductions for interest on legal form debt issued by NZ subsidiaries/NZ branches, but where Australia has treated the instruments as equity allowing Australian franking credits to be attached to dividend

11 See APN News & Media (market announcement found here: https://www.nzx.com/companies/APN/announcements/284588)

payments to Australian shareholders for Australian tax purposes. There is real doubt in any claim by IRD that these transactions are negative for the NZ tax base. On their face, the transactions allow interest deductions in NZ within the NZ thin capitalisation constraints for banks and the amount of interest deduction claimed in NZ is reduced because the interest paid is reduced by the benefit Australian investors get from the Australian franking credit. So these transactions are, prime facie, beneficial to the NZ tax base – IRD does appear to seek by contorted analysis to suggest a tax base loss from these transactions. Even if IRD should succeed in convincing Government/Parliament that there is a tax base loss from these transactions, action can again be by way of tailored legislation rather than the proposed hybrid mismatch reforms (we note that even in the UK/Australia, which are pursuing the proposed hybrid mismatch reforms, they are carefully considering the degree to which the reforms should apply to bank regulatory capital);

- ***Australian limited partnerships and dual use of interest deductions***: The use of Australian limited partnerships by NZ parent companies to make investments into Australia in ways which give rise to interest deductions on debt finance being available in both Australia and NZ does appear to be a genuine NZ tax base issue. There are existing rules that protect against some importing of tax losses from offshore (see for example, CFC loss quarantining rules and section IC 7 rules preventing loss offset by a company treated as tax resident of another country). If there is a desire to protect against this issue, tailored legislation can be enacted. Again, this does not justify the full scale of the proposed hybrid mismatch rules.

35 As we have suggested, none of the above examples demonstrate a NZ tax base issue that justifies from NZ's prospective introduction of the UK General Principle Overlay Approach to the proposed hybrid mismatch rules. The only example we have identified as a genuine NZ tax base issue is the Australian limited partnership. Our view is that this, and any other issue considered problematic, can be addressed by a tailored solution.

36 We are also aware of a variety of mechanisms for non-NZ tax reduction in the context of acquisitions of NZ businesses. These include use of unlimited liability companies/branches as a mechanism for flow through to foreign tax jurisdictions (in particular the US) of interest deductions from acquisition debt raised in NZ to finance NZ acquisitions. But these do not raise NZ tax base issues. Rather, in these types of cases, the introduction by NZ of the proposed hybrid mismatch rules can only be justified as a mechanism for foreign tax base protection which we address further below.

Context: The "a plague on all your houses" rationale is not appropriate and does not justify the General Principles Overlay Approach in NZ

37 Discussions with IRD officials suggest that from an international perspective there is a measure of "utu" (revenge/payback) for international corporate behaviour that underlies the rationale for the OECD BEPS Project generally and, in addition, the proposals in the OECD Hybrid Report. Tired of continually being a step behind the intricate schemes of multinationals and their tax advisors, the proposals in the OECD Hybrid Report are intended to be designed so that, irrespective of how a taxpayer tries to get to the end result of tax reduction by a D/NI mismatch, their efforts are defeated by the new rules.

38 With that emotional style of rationale in support, the suggestion from officials is/might be: "don't talk to us about the impossible complexities of these rules and the increased compliance costs, you (the multinational corporates) have brought those on yourselves."

39 Even accepting the likelihood that there is a measure of truth in this in the European/US contexts, in our view the NZ experience does not in fact justify this response. That this is the case is evident from the real difficulty in identifying any significant systematic NZ tax loss from the types of transactions targeted by the OECD Hybrid Report.

Context: The "no go" zones rationale is not an appropriate rationale in NZ

40 The idea that the rules are deliberately complex/ virtually incomprehensible at the level of specific implementation and are designed to just create "no go" areas is in our view simply not a plausible proposition. This is because the rules cover potentially such a wide array of commercial activity that they simply cannot all be packaged up and placed in a "no go" area:

- Differing tax treatments between countries of branches/permanent establishments and limited partnerships bring the rules into play;
- Cross-border acquisitions with deferred purchase prices are potentially subject to this regime;
- Repurchase transactions/short sales and equity securities lending transactions are within the regime. In international markets there will be billions/trillions of dollars in the transactions, much of which will not be tax driven; and
- Bank regulatory capital raising may be within the regime.

41 It is not plausible to suggest that the rules in these areas should be deliberately complex/virtually incomprehensible at the level of implementing specific transactions so as to create "no go" areas in these zones. Indeed even in the UK/Australia context specific exceptions are being considered for bank regulatory capital raising and modest repo and short sale/securities lending transactions by traders i.e., the UK/Australia are prepared to tailor their response according to their economic interests.

Context: Limited to Intra Group Transactions and "structured arrangements" (i.e. tax avoiders)

42 We accept that, prima facie, the OECD Hybrid Report rules appear to be directed at broadly the correct target—being controlled groups of companies (who do have control of the full set of transactions that they enter into) and "structured arrangements" generally to which a taxpayer is a party. For this purpose, a taxpayer will not be party to a "structured arrangement" if it could not have been reasonably expected to be aware of the hybrid mismatch *and* did not share in the value of the tax benefit resulting from the hybrid mismatch. However, while aimed at the correct target, we can foresee significant issues for companies on audit (even if no evil being evident).

43 First, as regards the hybrid financial instrument rule, the OECD Hybrid Report suggests that parties do not need to be in a "control group," they simply need be

"related parties:" this is a lower 25% threshold for association particularly when aggregation rules are considered.

44 Secondly, the objective test for "structured arrangements" means that there is a real risk of overreach. Given the rigorous nature in which tax authorities conduct audits, taxpayers may face considerable costs when faced with an allegation by tax authorities that the taxpayer knew or "could reasonably have been expected to be aware" that a hybrid mismatch existed. Further, demonstrating that a taxpayer did not share in any of the tax benefits arising from the hybrid mismatch may be an expensive/complicated process requiring specialist investment banking advice. This test creates an opening for tax authorities to deploy considerable pressure and extract payments by way of settlement in order to bring a tax dispute process to an end.

Context: NZ should not adopt the mind-boggling complexity/uncertainty created by General Principle Overlay Approach

45 Our attempt at a simple outline of the recommendations in the OECD Hybrid Report cannot fully disguise the scale of the complexity that is involved. The Report is more than 450 pages of text, with 300 of those pages dedicated to 80 examples. To give some sense of this, working with one of NZ's top tax policy officials, our Chapman Tripp tax team had the pleasure of spending around 2 hours debating just one of the examples. At the end of that time there was no consensus as to whether the result in the example was correct; and this is before there is any legislation (to those who are tax practitioners, the language of the legislation often obscures, rather than clarifies, the principles). We discovered that even assessing whether a D/NI result occurs is intricate, given that NI arises when an item is not included in "ordinary income" as defined (a definition which excludes income benefitting from an exemption; exclusion; credit or other relief).[12]

46 The complexity includes:

- The revolution of having NZ's tax treatment of a broad array of transactions turn on the tax treatment of the transaction in one or more other countries under their foreign law. The NZ tax treatment may turn on tax treatment in multiple counties, not just the treatment in one other country; consider for example Recommendations 4 (reverse hybrids) and 8 (imported mismatches). (Many object to this approach on the grounds that it undermines a country's national sovereignty as regards the imposition of taxes.)

- Where there is uncertainty in the foreign tax laws as to the outcome (whose tax law is after all certain in its scope?), that foreign tax law uncertainty is, under the OECD Hybrid Report approach, imported into the NZ law results. As a practical matter in the context of tax audits being run by two or more countries, current tax disputes practices do not allow for the tax administration in one country to resolve its tax position having regard to the outcomes of a determination of the tax position in another country. For example, if interlinked tax systems of the type envisaged in the OECD Hybrid Report are to be adopted worldwide, it would seem essential for there to be special mechanisms to allow for integration of tax disputes in relation to the application of those rules under the domestic tax laws in each country. The tax treaty dispute resolution mechanisms (themselves not very effective) do

12 See OECD Hybrid Report, paragraph 42.

not even apply in the context of interlinked domestic tax law disputes under the OECD Hybrid Report proposals. No such mechanism has yet been suggested. What might be necessary are delays in domestic tax dispute timing rules and an expanded ability to reopen tax returns (to allow the domestic effect of subsequent foreign law determinations to be taken into account).

- Although the OECD Hybrid Report suggests a series of principles, it leaves each country to adopt rules for their own tax systems. Each country therefore selects its own form of enactment, in its own language, and with its own exceptions. Even if all countries embraced the OECD Hybrid report fully (which they do not), there would be no reality to the idea that all countries would be enacting the same thing.

- Ongoing changes in the tax laws of other countries would affect NZ tax results. So as regards multi-year transactions, the requirement to take account of foreign tax laws in determining NZ tax treatment is an ongoing one which needs to be updated as foreign tax laws change.

- Use of the "General Principle Overlay Approach" would add to the complexity in terms of determining the practical effect of the rules enacted. It seems obvious and elementary that if the NZ legislature enacts tax legislation it should have considered and understood its scope and effect, and affirmatively have chosen to enact the legislation understanding its consequences. It had not occurred to the authors of the OECD Hybrid Report, for example, that the reverse hybrid rule would apply to NZ's foreign trust regime. Now it is a good thing that IRD have focussed on this possibility; otherwise, simply enacting the OECD Hybrid Report on a general principle overlay basis, without any further thought, would have had the effect that NZ's foreign trust regime would have been effectively repealed without the legislature even knowing that this was what it was doing. This would have been the case even though the Shewan report on NZ's foreign trust regime (concluded only in July 2016) took the view that no NZ taxation of foreign source income of a foreign trust under the existing law was an appropriate policy setting.[13] We suggest the tailored approach to ensure that other inadvertent changes in tax settings do not occur without thought.

47 Clearly this interaction of NZ law with foreign laws will dramatically increase the compliance costs for taxpayers—not only will taxpayers now require specialist tax advice from foreign jurisdictions to determine how NZ's own laws will apply to their potential deductions, the advice requires knowledge of the tax outcomes and tax filing positions for counterparties who may, especially in the context of "structured arrangements" between unrelated parties, have no shared interests and no desire to disclose such information. Moreover, in "structured arrangements" the suggestion may well be that a counterparty needs to warrant its foreign tax treatment and, if this proves to be incorrect and causes NZ tax loss, the foreign counterparty should indemnify the NZ counterparty for the NZ tax loss. This would overthrow norms of international risk allocation. If a foreign counterparty is not prepared to take an NZ tax risk, the NZ counterparty is left bearing NZ tax risks that turns on foreign tax treatment but without assurance as to the accuracy of the foreign tax treatment on which the NZ tax position relies.

13 John Shewan *Government Inquiry Into Foreign Trust Disclosure Rules* (New Zealand Government, June 2016), at paragraphs 4.18 and 13.25-13.28.

48 We do not necessarily expect mind-boggling complexity to stop the OECD Hybrid Report proposals in their tracks in NZ. We anticipate that more will be required by Inland Revenue before a tailored approach will be taken in NZ. But NZ is too small to ignore the costs of complexity. As Lee Sheppard observes in a 2015 Article:[14]

> "Why do Americans have such an appetite for complexity? Americans don't have to think about systemic administrative costs. … The United States is a very large country, with a very large economy, so administrative costs that would kill a smaller country are a pinprick on a rhinoceros hide".

49 In this context, it is self-evident that NZ is not a rhinoceros (noting also that it appears that the US itself will not adopt the OECD Hybrid Report proposals).

Context: NZ needs to recognise the flawed foundations of the Anti-Hybrid Mismatch Proposals

Not all countries will be in

50 A basic tenant of the 'country club' rationale is that all nations, particularly those for whom the rules were primarily developed, must actually be implementing the rules themselves. Without this global commitment, there is no justifiable reason why NZ should bear the implementation costs, compliance costs and complexity of a regime that benefits other nations if other beneficiaries will not share in that same burden. Though the IRD Discussion Document shows the NZ Government's "expectation that [other] countries that are part of the consensus will act,"[15] a survey of other nations shows that this is not likely to prove entirely accurate:

- Early adoption is currently spearheaded by the UK, having already enacted anti-hybrids legislation that will be effective on 1 January 2017.[16] While the UK is adopting almost the full spectrum of complicated rules, this is arguably justifiable given the potential scale of hybrid abuse in the UK. Notwithstanding these problems, UK has targeted exemptions for regulatory capital,[17] stock loans and repos which will largely reduce the impact of these rules on its banks and financial traders, despite the likelihood that those groups are key beneficiaries of hybrid mismatch arrangements.

- Though without publishing any actual legislation, Australia has also made significant progress towards adopting anti-hybrid measures. From its public consultations, we expect that Australia will adopt versions of OECD's recommendations to be effective no earlier than 1 January 2018. Importantly however, Australia also proposes to modify OECD's recommendations where

14 Lee A. Sheppard, "BEPs Action 2(Hybrid mismatches), The Hybrid Hydra" (October 2015), Tax Notes International.

15 At 1.11.

16 Schedule 10, Finance Act 2016 c.24 (UK).

17 Despite indications from the UK that its exclusion of regulatory capital is a temporary measure there is no certainty that regulatory capital will ever be included in a meaningful fashion, given that UK's earlier intentions to include it (see HM Treasury "Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements" (December 2014)) were successfully blocked by the industry.

necessary to advance its own interests.[18] Australia may also exclude regulatory capital.[19]

- The EU also intends to implement anti-hybrid legislation, having proposed two council directives that address hybrid mismatches in the context of broader tax reforms. EU measures differ depending on whether the mismatch occurs between two EU member states or an EU member state and a third party:

  (a) The directive to address hybrid mismatches between EU members is effectively a restatement of the primary rules contained in Recommendations 1, 3, 4 and 6, i.e. member states are instructed to deny deductions for payments made in the presence of a DD or D/NI outcome.[20]

  (b) In contrast, the directive to address external mismatches requires the implementation of both primary and secondary rules which includes the imported mismatch rule.[21]

- EU's proposals require EU member states to introduce domestic law by 31 December 2018 to give effect to the directive. Given the differences between each member's tax systems and intra-EU competition for inbound investment, one should not expect complete uniformity between the approaches of member states.

- China indicated an intention to introduce anti-hybrid rules in 2015, but we have not identified any publically available English guidance on what form these rules may take. However, fully-fledged implementation is unlikely as hybrid instruments in China are already curtailed to a large degree by its capital and foreign exchange controls.[22]

- Though US "check-the-box" rules are likely the largest facilitator of hybrid mismatch arrangements in the world, it seems likely that the US will only adopt token anti-hybrid measures, if any (President-elect Trump and Republican majorities in both the Senate and the House are not likely to lead to broader adoption of anti-hybrid measures by the US, but stranger things have happened!).[23] Consequently, Canada is also unlikely to adopt any meaningful anti-hybrid measures because it will not risk placing its multinational companies at a competitive disadvantage to those in the US.

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18 Limited reverse hybrid rules (no Recommendation 5); no limit for relief on foreign withholding tax (no Recommendation 2.2); potentially excluding the imported mismatch rule (Recommendation 8).

19 AT Board was due to report back on regulatory capital by the end of July 2016 but had not done so at the time of writing.

20 Article 9: Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the market (COM (2016) 26 Final).

21 Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (COM (2016) 687 Final).

22 KPMG "China – response to BEPS" (2 June 2016) KPMG <https://home.kpmg.com/xx/en/home/insights/2016/06/beps-action-plan-china.html; http://www.internationaltaxreview.com/Article/3511704/China-at-the-forefront-of-global-BEPS-implementation.html> (accessed October 2016).

23 Powerful members of the US legislature such as Senator Orrin Hatch (Utah) and Speaker Paul Ryan (Wisconsin) are publically opposed to any BEPS initiative that could potentially detriment US taxpayers and have stated that the US "shouldn't be negotiating agreements that undermine our own interests for the sake of some supposedly higher or nobler cause. The interests of the United States – our own economy, our own works, and our own job creators- should be our sole focus."

- At the time of writing, no concerted initiatives had been reported for Singapore or Japan.[24]

51 Although the rules have been designed to allow for the possibility of non-adoption by all countries, in the present context it would be naïve for NZ simply to adopt a UK General Principle Overlay Approach without more thought. In our view, a tailored approach is required.

Tax Havens are protected; imported mismatch rules problematic

52 As a general rule, the OECD Hybrid Report proposals do not attack tax advantages from, for example, paying tax deductible payments from companies in high-tax countries as income to companies established in tax havens or low-tax countries. Broadly, it is only tax reduction by virtue of the hybrid nature of the instrument or the hybrid nature of the entity that is targeted (although there is room under the regime for technical foot-faults that produce increased tax liabilities).

53 In this sense, tax havens/low-tax countries can be regarded as protected and encouraged by the OECD Hybrid Report. In our view, this state of affairs seriously undermines the integrity of what is being done. By not addressing the tax haven/low-tax question, the OECD Hybrid Report proposals may prove to be largely ineffective in taxing returns on multi-national capital flows. To some considerable extent it can be predicted now that in 10 years' time these rules may have proven to be largely ineffective in raising increased tax on returns on capital flows. How will governments and the public view the outcome if, for all this complexity/ compliance cost, there is no significant benefit in terms of taxation of returns on capital flows?

54 That result may well happen because nothing is done to attack investment in straightforward debt instruments from low tax/territorial tax jurisdictions (e.g. Ireland/Switzerland/Singapore/Hong Kong). So the corporate response can be expected to capitalise more and more treasury operations based in those jurisdictions. It can also be anticipated that over time an increasing number of countries will operate a territorial or low tax regime to attract this type of activity. In this paradigm, clearly high value jobs will increasingly locate in those jurisdictions who use their tax system to attract this type of activity:

> "Planners are responding to European countries' efforts by using plainer debt instruments under which payments are made to low-tax jurisdictions. The BEPS report is not an anti-conduit effort. It does not cover back-to-back loan schemes that do not involve hybrids. And it doesn't ask questions about the tax rate imposed on a deductible item as long as the payee has to recognise it under local law".[25]

This likely ineffectiveness is one factor to be taken into account in our conclusion that the tailored approach is appropriate.

55 In principle we object to the imported mismatch rule on the grounds that it has the potential to have a negative impact on NZ's attraction of FDI. We also make the point also that the imported mismatch arrangement rule seems to have a real problem in terms of the integrity of what is being done. The report suggests that

24 Deloitte "BEPS Actions Implementation Matrices" Deloitte <https://www2.deloitte.com/global/en/pages/tax/articles/beps-action-implementation-matrices.html> (accessed October 2016).

25 Lee A. Sheppard, "BEPS and EU Progress Report" (June 2016) Tax notes International at 1217.

this rule should only apply where the funds can be traced from the hybrid mismatch to the country that is importing the mismatch. Consider Example 8.1 (page 341- 3 and in particular paragraph 8 of the Example; an extract of which is included as Example 4 in the Appendix to this article). An approach that depends on "tracing" of funds through multiple layers higher up in a multinational is most unlikely to be effective — it requires mass tracking of all intragroup transactions much higher up in a corporate chain to determine whether interest deductibility in NZ is allowed; while at the same time allowing anyone who wants to avoid the rule to avoid it by setting up a fungible treasury function at some point in the chain between NZ and the higher tier hybrid financial instrument that breaks the "tracing" chain required before the rule can operate. If there is to be an exclusion where there is an inability to trace, the rule will not be effective and in our view should not be adopted in the first place. The fact that an exclusion of this type is contemplated strongly suggests that the proposal had a significant degree of overreach from the outset.

Country Club to protect other countries' perceived aggregate interest vs NZ's interests

56 That the whole rationale for the hybrid mismatch payments rules is highly questionable can be seen from a simple example in two real life scenarios:

(a) Assume Australia is, in relation to regulatory capital instruments, to allow franking credits to Australian investors for franking credits attached to payments that are treated as tax deductible interest payments from NZ branches of Australian banks. If that is the case, what purpose is NZ achieving by enacting the hybrid financial instrument rule? If Australia affirmatively chooses not to counteract the tax benefit on these instruments, what is NZ acting to protect when it deploys the hybrid instruments rule to deny the interest deduction in NZ? Note in particular that availability of the franking credits actually reduces the interest paid to the Australian investor and therefore reduces the interest deduction against the NZ tax base that would be claimed if Australian franking credits were not allowed in Australia.

(b) To similar effect, what purpose is NZ achieving if NZ deploys the hybrid instruments rule to deny a deduction in NZ for a payment treated as interest expense by NZ in respect of a foreign investor located in a country that treats the payment as a dividend and which has deliberately chosen not to adopt the rule in Recommendation 2 (i.e. has chosen not to adopt a rule the equivalent of NZ's section CW 9(2)).

57 We find these questions particularly difficult to answer. Given that Australia/the foreign country has deliberately chosen not to act in conformity with the OECD Hybrid Report proposed rules, NZ's denial of interest deductions in the examples clearly would not be advancing Australia's/the foreign countries' perception of its own interests. In this case, it seems that NZ is supposed to act to deny tax deductions on what NZ sees as legitimate interest expense because of some broader bond to support the interests of a broader "country club" beyond the counterparty country. NZ offers to step into the breach to honour the interests of the "country club" even though the counterparty country has deliberately chosen not to support the "country club". Really??

58 Professor Graeme Cooper suggests a slightly different, but similar, issue with the OECD Hybrid Report rule:

> "One remarkable, but unstated, implication arising from [the OECD Hybrid Report rules] … is the conclusion that these rules are attempting to ensure all income must be taxed at least once, but it does not matter where. Whether the tax is collected under the response rule or the defensive rule is immaterial. Indeed, the positions expressed in the six rules are not reached on the basis of any overarching principle. The Recommendations Paper deliberately avoids any attempt to determine which state has lost revenue and which state should benefit by a greater revenue collection. Consequently, which state ultimately collects revenue from implementing the recommended rule could be arbitrary or driven by strategic behaviour."[26]

59 He understandably views this as at odds with the BEPS mantra that profits should be taxed "where the economic activities that generate the profits are performed and where value is created." He also raises, and we agree with, the oddity of the constant use in OECD Hybrid Report proposals of denial of deductions as the solution to all hybrid problems, even if they are driven by something other than a deduction.

60 Where a country does not introduce the rules at all, or only implements certain rules, or chooses to leave holes in its rules, NZ needs to recognise that adopting every recommendation in the OECD Hybrid Report will result in the entire increased tax impact of the rules occurring in NZ (and not in the foreign counterparty country). NZ needs carefully to consider the economic consequence of that tax impact. In these circumstances, it simply cannot be that NZ blindly adopts the full rules without question.

Double tax is imposed

61 Oddly, although seeking to eliminate double non-taxation, the OECD Hybrid Report proposals result in imposition of double taxation in a number of situations. For instance, in Example 3 in the Appendix the interest deduction is denied to B Co even if A Co is paying tax on the sales process. Similarly, the proposals promote double taxation by ignoring withholding taxes in determining whether a hybrid mismatch arrangement produces a D/NI outcome, i.e. the OECD Hybrid Report rules might apply to treat a transaction as producing a NI result, even where source country withholding tax is imposed (withholding rates under domestic law can be as high as 30%). The OECD Hybrid Report explains the rationale for this as follows:

> [at 407] "The function of withholding taxes under the laws of the payer jurisdiction is generally not to address mismatches in tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source."

62 The logistics of tax disputes in two different countries also create a significant risk of double taxation for corporate groups—resolution of uncertainty in one country may not come in a timely manner for another.

63 The logic of the framework is called into further question because, even where the OECD Hybrid Report rules actually operate to deny a deduction for interest expenses, the OECD still suggests that the payments be treated as interest for the purposes of imposing withholding tax (i.e. as if the deduction had not been denied). The NZ Government suggests that this approach be accepted at paragraph 11.4 of the IRD Discussion Document.

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26 Graeme S. Cooper "Some thoughts on the OECD's recommendations in Hybrid Mismatches" (July 2015) Bulletin for International Taxation.

Context: NZ's policy to attract FDI requires the Tailored Approach

NZ Government policy seeks to attract additional FDI

64 Current NZ Government policy announced in July 2015 seeks to attract increased FDI under a new NZ Investment Attraction Strategy. An extract from the Cabinet Paper approving the strategy states the principles and sets a clear target as follows:

> "Achieving the government's goal of building a strong competitive economy with increasing numbers of higher paid jobs will require ongoing significant increases in business investment, and international investment will be an important source of capital to fund this increase. High quality international investment will assist with increasing exports to 40 percent of GDP, help lift research and development intensity to one per cent of GDP, and bring additional benefits to the economy. We have not yet been as effective as we can be in attracting the type of high quality international investment we need.
>
> …
>
> *Theme 1: attract high-quality foreign direct investment in areas of competitiveness for New Zealand*
>
> …
>
> ***Target***
>
> We propose the target for theme 1 be to facilitate investments with a potential direct economic impact of $5 billion over three years."

65 Moreover, the FDI piece is part of a broader integrated framework that includes attracting overseas investment in R&D and attracting entrepreneurs to reside in NZ. This strategy was stated to be based on "an aligned, whole-of-government effort to attract high-value FDI".

66 This strategy is consistent with economic research that shows that FDI brings benefits to a country: it creates economic growth, increases jobs, lifts productivity and also provides access to new ideas and technology.[27] In contrast, a lack of FDI may result in increased interest rates, reduced consumer spending and eventually, reduced employment.

67 So any proposed adoption of the OECD Hybrid Report proposals must first address carefully the question of potential adverse impact on the existing NZ Government policy under which NZ seeks to attract more FDI.

68 The IRD Discussion Document does not address the consequence of adopting the OECD Hybrid Report proposals for NZ's FDI attraction strategy. The draft IRD tax framework for inbound investment (June 2016) at least begins the discussion:

> "An important priority for the future will be to consider measures to address BEPS. This includes consideration of rules to address hybrid mismatches and the possibility of tighter interest limitation provisions. When addressing these

27 NZIER *Foreign Direct Investment in New Zealand: A brief review of the pros and cons* (NZIER, March 2016) at 3; MBIE *Business Growth Agenda: New Zealand Investment Attraction Strategy* (MBIE, 2015).

issues the focus will be on doing what is in New Zealand's best interest but, at times, this may mean co-operating with other countries to achieve a more efficient worldwide outcome and seeking to gain our share of a bigger worldwide pie."[28]

69 Indeed, the IRD paper confirms the need for careful testing of each of the BEPS initiatives, including the OECD Hybrids Report proposals:

> "Each [BEPS initiative] needs to be looked at critically from New Zealand's point of view."[29]

International tax competition and sensitivity of FDI to tax; adverse impact on NZ FDI attraction of OECD proposals

70 We do not address here the detail of the tax framework as regards FDI. Although increases in effective tax rates do not have a perfectly linear relationship with reductions in FDI, OECD studies nevertheless conclude that for every 1% increase in effective tax rates FDI will be reduced by 3.75% on average.[30] There is therefore legitimacy to the proposition that NZ seeks to attract FDI in a context of international competition as regards taxation on FDI. IRD's commentary acknowledges the relationship between tax levels and FDI generally:[31]

> "Taxes can have important effects on the incentives for non-residents to invest in, or lend money to, NZ… Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to NZ."

71 The existence of economic rents (foreign investors who need to be in NZ to make their profits and are therefore less sensitive to NZ taxes) and foreign tax credits for offshore investors in their home jurisdictions mean that it is difficult to assess with precision the impact of NZ taxes on the ability of NZ to attract FDI. We believe that the type of marginal increase in FDI that the NZ Government seeks to attract under its new policy is likely to be more sensitive, rather than less sensitive, to the imposition of NZ tax. This FDI is not occurring naturally in NZ now so it seems to us less likely that this FDI falls into the economic rents category. If that assessment is accurate then NZ needs to take particular care as regards the potential for adverse effect on NZ FDI attraction from introduction of the OECD Hybrid Report proposals.

72 Current FDI into NZ arises as follows:[32]

Country	FDI in 2016	Total NZ FDI (% of total)	Position as regards OECD Hybrid Rules?
Australia	$537m	$50,659m (51.5%)	Yes

28 Policy and Strategy at NZ Inland Revenue *New Zealand's taxation framework for inbound investment: a draft overview of current tax policy settings*, (June 2016) at page 26; and see pages 20-22.

29 Ibid 28, at 22.

30 OECD *Tax Effects on Foreign Direct Investment* (2008) Policy Brief. See generally IRD June 2016 draft overview; OECD – Executive Summary of Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis (2007); NZ Tax Review 2001 Final Report, at page 20-21,75-83 and Annex E at 133.

31 Ibid 28, at 3.

32 NZ Trade & Enterprise Statistics <www.nzte.govt.nz/en/invest/statistics/> (accessed October 2016).

United States	$100m	$7,686m (7.81%)	Unlikely
Singapore	$418m	$5,651m (5.74%)	Unknown
Hong Kong	$109m	$5,503m (5.6%)	Unknown
United Kingdom	$-956m	$5,367m (5.45%)	Generally yes
Canada	$339m	$4,275 m(4.3%)	Unlikely
Netherlands	$718m	$4,235m (4.3%)	Likely yes (EU)
British Virgin Islands	$3,009m	$3,009m (3.06%) (Assumed from other countries—UK?)	Unlikely

73 Also of relevance are expectations as to the countries from which future FDI into NZ is expected to originate. Given expanding trade relationships with the Asian region, it seems quite plausible that FDI into NZ from the Asian region may over time increase in significance.

74 In assessing the significance of Australia's FDI into NZ (51.5% of the stock of FDI) and the extent of Australia's adoption of the OECD Hybrid Report proposals, it needs to be observed that the vast majority of Australia's FDI is in the financial and insurance sectors (76% in 2012)[33]. In this regard NZ needs to be close to the Australian position on application of the OECD Hybrid Report proposals as regards bank/ insurance company regulatory capital (this is still under review in Australia).

75 Important for any foreign investor is understanding NZ's effective tax rate on their investment. This is an average of the effective NZ tax rate on equity investment (28% corporate tax rate) and the effective NZ tax rate on any related party debt investment (generally 10% NRWT on related party interest and a 10% limit under the relevant NZ tax treaty, assuming deductibility in NZ of interest on the related party debt). NZ's thin capitalisation limit constrains total debt financing including both related party debt and non-related party debt (generally to 60% of total assets).

76 Critical then to FDI investors is for them to understand in particular the extent to which they are able to deduct interest on related party debt. It is here that NZ adopting the OECD Hybrid Report proposals becomes problematic from the non-NZ investor's perspective.

77 For example, assume for the moment that the USA/ Canada/ certain Asian countries do not adopt the OECD Hybrid Report proposals. If NZ does adopt the OECD Hybrid Report proposals in full, non-NZ investors from those countries face the possibility that NZ interest deductions in relation to related party debt may be denied (and their after tax returns reduced) in circumstances where:

- the related party lending to the NZ entity/ branch is by way of a hybrid financial instrument (e.g. MCN) that otherwise produces a D/NI outcome (this is the result of Recommendation 1 where the country of residence of the investor has not adopted Recommendation 2, for example the country of residence of the investor does not prevent a tax exemption for the payee where interest payable on the MCN is tax deductible to the payer);

33 Statistics New Zealand <http://www.stats.govt.nz/tools_and_services/newsletters/economic-news/may-13-direct-investment-with-australia.aspx.> (accessed October 2016).

- interest on the related party lending is paid to an offshore hybrid entity or reverse hybrid entity, in which case issues as to interest deductibility in NZ may arise under either Recommendation 3 or Recommendation 4; or

- the related party lending is linked under the imported mismatch rules to a hybrid mismatch higher in the corporate group.

78 How then will those investors evaluate NZ as an investment destination? One thing is sure—they will need to understand the nature of any risk they have that interest expense that they are expecting to be tax deductible in NZ may in fact prove to be non-deductible. This is potentially of direct and immediate importance to the investor's after tax returns. If all the world adopted the proposals on identical terms then the risks and compliance costs of the OECD proposals could be expected to be similar for all investment destinations and NZ's adoption should not in that case be problematic in terms of FDI attraction.

79 But our example presumes what is likely to be the reality: that USA/ Canada and significant parts of Asia do not adopt the rules at all or do not adopt the rules in full. If this is the case then investors from those countries will have options to invest in countries other than NZ where they are not subject to the risks of reduced after tax returns (by elimination of the benefit of arrangements that are available to produce lower tax imposts for returns on their investment or the risk of such an adverse outcome) and where they are not subject to the compliance burden of trying to ensure that the OECD rules in fact do not harm. We see real potential for adoption by NZ of the OECD rules to adversely affect the NZ Government's policy of attracting FDI from investors in those countries.

80 There seems to be more complexity in assessing the relative position of investors from countries that adopt the OECD Hybrid Report proposals when comparing investment in: NZ (if it adopts the OECD proposals); and investment in another country where the proposals have not been adopted. Critically this will also depend on whether the investor country has also adopted the secondary defensive rules. But what is clear is that the non-adopting country into which the investor may invest will be a far simpler proposition from the perspective of the investor determining their tax liabilities than New Zealand will be if it adopts the OECD Hybrid Report proposals in full. In particular, the investment into the non-adopting country by the non-NZ investor will not have interest deductions potentially denied under the hybrid financial instrument rules, the disregarded payment by a hybrid rule, the payment made to a reverse hybrid rule or the imported mismatch arrangement rule; and the investor into the non-adopting country will not have to deal with the compliance burden of the OECD rules in calculating its non-adopting country tax liability.

81 Whether a lower tax in-country burden for the investor in a non-adopting country transforms into higher after tax returns (including investor country tax) for the investor is another issue and is dependent on the way in which the investor structures its investments and the degree to which the investor country adopts the OECD recommendations. Some of the OECD rules have secondary responses that are relevant to the investor in the case of investment in non-adopting countries and they may trigger tax liability in the investor's country of residence (for example as regards hybrid financial instruments and disregarded payments made by a hybrid entity, the secondary responses in the OECD rules adopted by the investor country may trigger a tax liability for the investor in its country of residence). But for some of the other rules there is no secondary response (for example there is no secondary rule for imported mismatch arrangements and none for payments made to a reverse

hybrid—see generally the chart at page 20 of the OECD Hybrid Report for a useful chart providing an overview of the proposals). So in these types of cases where there is no secondary rule (and if the investor country has not adopted other suggested OECD amendments to buttress its offshore tax regime):

- an investor group investing in the future into an NZ that adopts the full OECD Hybrid Report proposals may have significantly higher tax costs in NZ than they would do if they invested in the non-adopting country; and

- those lower tax costs for the investor group in the non-adopting country may well produce higher after tax returns to the investor group, even after taking account of investor taxes. This because, even though the investor's country of residence has adopted the OECD Hybrid proposals, those proposals do not, as regards the three rules identified, have secondary responses that affect the investor's tax liability in its country of residence.

Preliminary thoughts on the tailored approach NZ should take

82 This paper advocates for New Zealand to take a "tailored" approach to the OECD Hybrid Report proposals. Under this tailored approach:

- NZ should reject any presumption that, without the need for further thought, the UK General Principle Overlay Approach should be adopted;

- NZ should make deliberate policy decisions in NZ's interest as regards each of the OECD policy recommendations and the extent to which each is adopted by NZ. To the extent the OECD proposals are to be adopted, specific new rules should be integrated into the existing statute (not served up as a stand-alone overriding subpart of the statute);

- some of the OECD Hybrid Report proposals should not be adopted at this time. At this stage our view is that rules that deny to foreign direct investors NZ interest deductions which would otherwise be allowed within NZ's existing framework should not be adopted and this would include the imported mismatch rule/ the rule as regards disregarded payments by hybrid entities and the rule as regards payments made to a reverse hybrid.

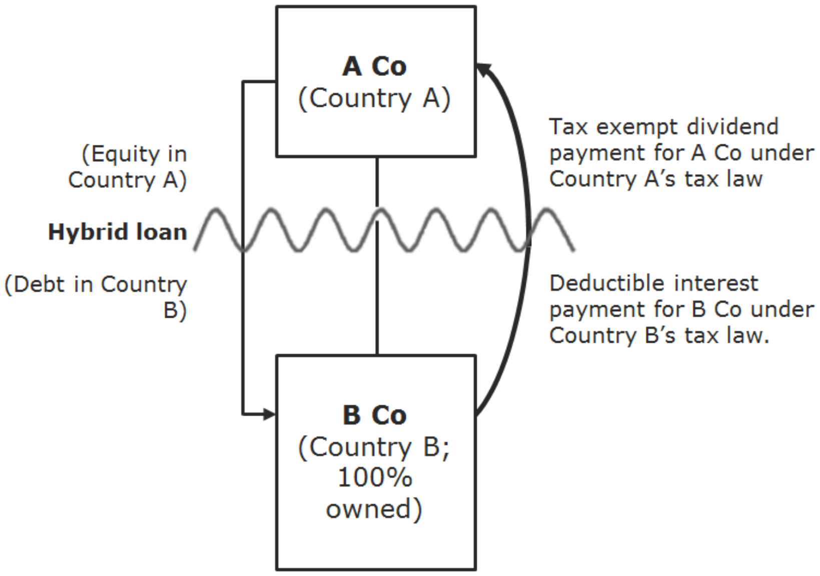
83 The compelling reason for the suggested "tailored" approach is that adoption of the UK General Principle Overlay Approach, without further thought, would potentially have a significant adverse impact on the NZ Government's current policy emphasis on attracting more foreign direct investment into NZ. We believe that this issue has not yet been fully analysed and that the analysis needs to be undertaken and fully tested before adoption of the OECD Hybrid Report proposals by NZ.

84 In addition to the difficulties that the OECD proposals cause as regards attraction of FDI, we remain concerned that in a number of respects that we have outlined above the principles underlying the OECD proposals are flawed.

APPENDIX: FOUR EXAMPLES OF THE OECD HYBRID REPORT RULES IN ACTION

The following four examples are taken from the OECD Hybrid Report (here conclusions are just summarised; full analysis is available in the report).

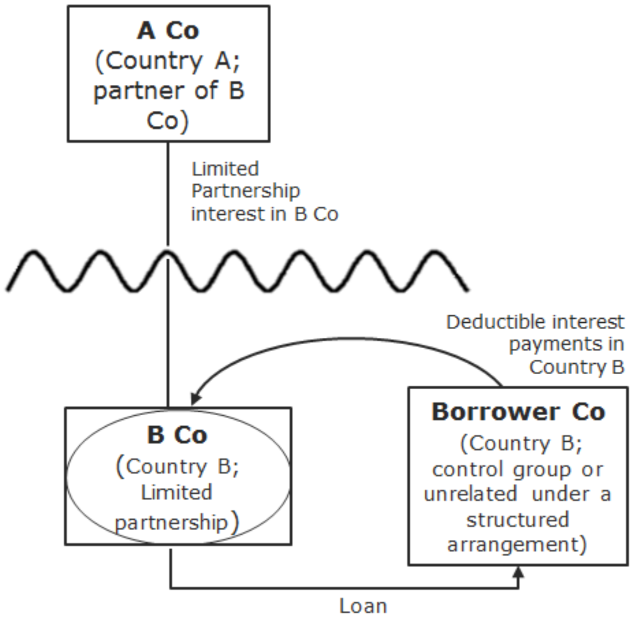
Example 1: OECD Hybrid Report Example 1.1 (page 175) — Interest payment under a debt/equity hybrid



If Country A treats the payment from B Co as a tax-exempt dividend (i.e. Country A does not adopt Recommendation 2 of the OECD Hybrid Report and does not have a rule equivalent to NZ's section CW 9(2)), Country B would apply the hybrid financial instrument rule to deny B Co's interest deduction.

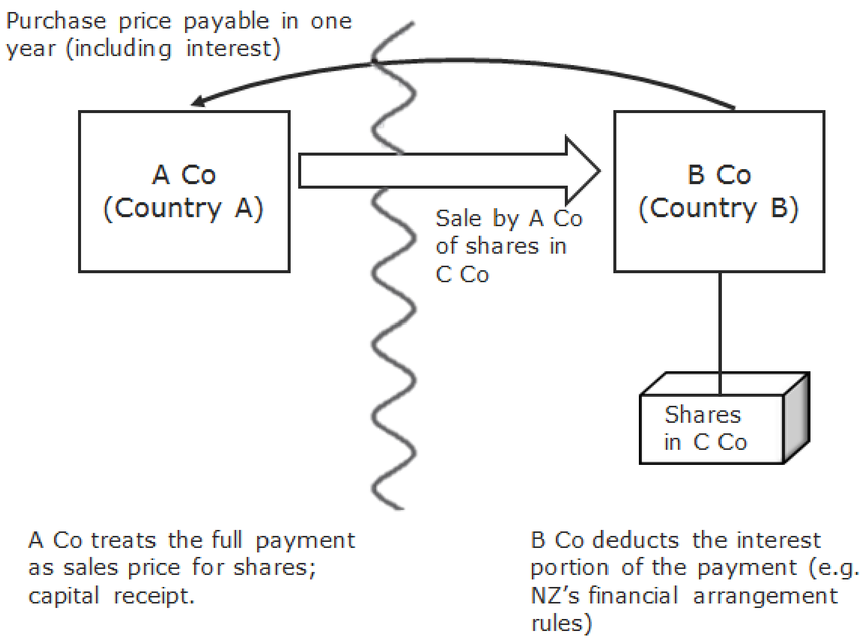
If Country A adopts into its domestic law Recommendation 2 of the OECD Hybrid Report (i.e. a rule equivalent to NZ's section CW 9(2)), Country A would tax the payment on the hybrid loan. As a result, Country B will allow B Co the tax deduction for the interest payment.

Example 2: OECD Hybrid Report Example 4.1 (page 299) — Use of a reverse hybrid



If A Co under Country A tax law treats the interest payments as derived in Country B (i.e. under Country A tax law, B Co is a separate entity) and B Co under Country B tax law treats the interest payments derived in Country A (i.e. under Country B tax law, B Co is transparent), there will be no recognition of income in either jurisdiction. In this situation, Country B would apply the reverse hybrid rule to deny Borrower Co's interest deduction.

Example 3: OECD Hybrid Report Example 1.27 (page 246) — Interest component of purchase price

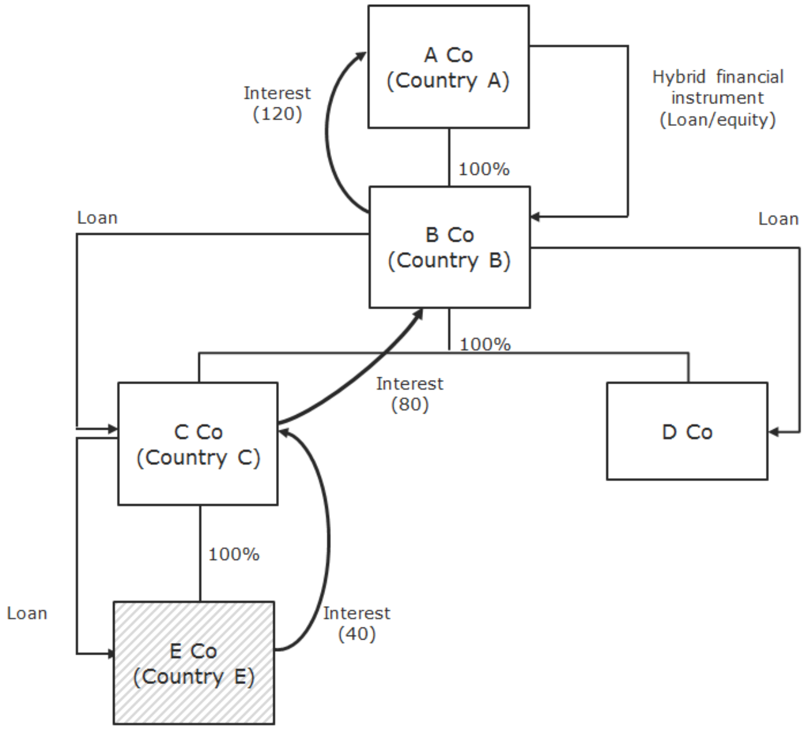


Because B Co claimed an interest deduction which was not matched by a corresponding ordinary income receipt for A Co, Country B would apply the hybrid financial instrument rule to deny B Co's interest deduction. If Country B has not implemented the hybrid financial instrument rule, or does not counteract the mismatch, Country A would apply the defensive rule and include that interest payment in the ordinary income of A Co. This result applies even if A Co has included the full purchase price (including the amount that from Country B's perspective is the interest component) in its amount realised and on which capital gains tax is paid under the laws of Country A.

As suggested by NZ's Discussion Document (at paragraph 5.29), if A Co was a trader and included the entire payment in their ordinary income, the hybrid financial instrument rule could still be applied by Country B to deny B Co's deduction. This is because "the application of the rules depends on the tax treatment of a payment of "ordinary status,""[34] i.e. B Co could be treated as if it was dealing with entities as holding the shares on capital account. In that situation, there is no actual D/NI outcome, but because one could have theoretically existed, B Co will still be denied an interest deduction.

34 At 5.29.

Example 4: OECD Hybrid Report Example 8.1 (page 341) — Structured imported mismatch rule



In this situation, A Co and B Co are parties to a hybrid financial instrument. By way of on-lending arrangements between B Co and C Co, and then C Co to E Co, OECD's Hybrid Report suggests that the hybrid mismatch occurring between A Co and B Co is 'imported' into Country E, i.e. irrespective of whether E Co's interest deduction is matched by interest income by C Co in Country C, E Co's interest deduction in Country E is viewed as offset at the group level by the hybrid mismatch between A Co and B Co under the laws of Country A and Country B. In this situation, Country E would apply the imported mismatch rule to deny E Co's interest deduction even though the hybrid mismatch between A Co and B Co does not affect Country E's tax base. (Note: This rule appears to be premised on an ability to trace funds through different jurisdictions. If as is almost inevitably the case, the group operates via a centralised treasury function under which moneys are fungible it appears that the imported mismatch rule does not apply. With a hole this large, the question arises as to whether the rule should be introduced at all.)

SUBMISSIONS

BEPS – Strengthening our interest limitation rules

Submissions received for the Government's discussion document *BEPS – Strengthening our interest limitation rules* (March 2017).

Number	Submitter
001	SKYCITY Entertainment Group Limited
002	Oxfam New Zealand
003	Olivershaw Limited
004	First Gas Limited
005	First State Investments
006	New Zealand Council of Trade Unions Te Kauae Kaimahi
007	TP EQuilibrium | AustralAsia
008	QIC Private Capital Pty Limited
009	AMP Capital Investors Limited
010	Powerco Limited
011	KPMG
012	Plenary Origination Pty Ltd
013	Chartered Accountants Australia and New Zealand
014	Ernst & Young Limited
015	PricewaterhouseCoopers
016	AMP Capital Investors (New Zealand) Limited
017	Russell McVeagh
018	Deloitte
019	ANZ Bank New Zealand Limited
020	Bank of New Zealand
021	Methanex New Zealand Limited
022	New Zealand Bankers Association
023	American Chamber of Commerce in New Zealand Inc.
024	Westpac
025	Corporate Taxpayers Group
026	New Zealand Law Society
027	InfraRed

#001

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30 March 2017

BEPS –Interest limitation rules
c/o Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
WELLINGTON 6140.

By email: policy.webmaster@ird.govt.nz

Dear Madam

The following brief submission has been prepared by SKYCITY Entertainment Group Limited on the discussion document released by officials titled "BEPS – Strengthening our interest limitation rules".

SKYCITY Entertainment Group Limited is a member of the Corporate Taxpayers Group. SKYCITY supports the objective to ensure New Zealand collects its fair share of tax from investments made by foreigners in New Zealand. SKYCITY is listed in both New Zealand and Australia and its share register shows approximately 66% foreign shareholders. Its largest shareholders are primarily custodial holdings.

In addition, SKYCITY has substantial investments in Australia and operates casinos in both Adelaide and Darwin. The operators of the two casinos are Australian resident companies.

The discussion document proposes that the current thin capitalisation ratios of 60% for inbound investment and 75% for outbound investment are retained but the way the ratio is calculated will be narrowed by including non-debt liabilities and by removing the current provision that allows the revaluation of assets for the purpose of the thin capitalisation calculation when that revaluation is not included in the entity's financial statements.

The effect of these two changes is likely to have a significant impact on the interest deductibility of entities subject to either or both the inbound or outbound thin capitalisation rules. If an entity breaches the outbound thin capitalisation rules in New Zealand, having borrowed to invest or loan funds cross border, it may then breach the inbound thin capitalisation rules in the country into which it is investing, and would be subject to the denial of interest deductions in both countries for the same investment.

It appears from the discussion document New Zealand is moving to align its thin capitalisation rules with those of Australia. However, there are significant differences in the approach proposed under this discussion document and the Australian legislation, in particular with regard to revaluation of assets and including intangible assets in the thin capitalisation calculation.

The Australian legislation provides that as a general rule an entity must comply with the accounting standards when revaluing its assets for the purpose of calculating its thin capitalisation liability. However, an entity can choose to revalue an asset, including an intangible asset for these purposes as long as it meets stringent requirements. The valuation must be in writing and must be made before the due date for lodging the relevant income tax return. If the revaluation is included in the financial statements, an external expert is not required to undertake the revaluation, but if the revaluation is not included in the financial statements, the assets must be revalued by a person who is an expert in valuing such assets and whose pecuniary and other interests could not reasonably be regarded as being capable of affecting the person's ability to give an unbiased opinion in relation to the revaluation. We have attached a copy of the relevant Australian legislation.

SKYCITY submits that if New Zealand is not going to follow the best practice as set out by the OECD and limit interest deductions by way of an EBITDA ratio, and is going to tighten its current thin capitalisation rules in line with the Australian legislation, it should adopt the same position as Australia on revaluation of assets and include intangibles in the asset calculation and not exclude this aspect of the legislation. An entity that does not wish to include the revaluation of an asset in its financial statements but wishes to include the current value in its thin capitalisation calculation could be required to have the assets valued by a member of the New Zealand Institute of Valuers. In SKTCITY's opinion, a revaluation of assets by an independent professional firm for the purposes of the thin capitalisation regime would result in a greater level of scrutiny than may be the case if the assets were not revalued by an expert but were instead revalued by the company directors or employees.

In some cases the accounting standards may preclude the recognition of an intangible asset from being included in the financial statements. An example of this in New Zealand is the SKYCITY Casino licences. Banks lend on the value and earning potential of intangibles such as a licence and, with sufficient rigour imposed on the process, there should be no reason for such assets to be excluded from the thin capitalisation calculation.

There can be many reasons entities do not include revaluations in their balance sheets, and entities taking this conservative approach should not be penalised by the removal of the net current valuation method from the list of available valuation methods for thin capitalisation.

The discussion document states that the objective of the thin capitalisation rules is to prevent companies from shifting profits out of New Zealand through excessive interest deductions. Does a thin capitalisation regime that focuses on debt, equity and assets and not actual earnings or profits achieve this goal? If the regime is to be based on debt, equity and assets, then the calculation should include all measurable assets, including intangible assets, at current net value.

As noted in the discussion document, New Zealand relies heavily on foreign direct investment to fund domestic investment. If the majority of countries from which New Zealand sources investment adopt the recommendations set out in the OECD report then the EBITDA ratio method will be more widely understood than a method based on a ratio of debt to equity. The OECD proposals are designed to ensure that profits are taxed where the underlying economic activity occurs and where value is created. It is not clear that a regime which focuses on debt, equity and assets rather than actual earnings achieves this result.

SKYCITY submits that the aspects of the Australian thin capitalisation regime relating to the revaluation of assets by an independent expert should be included in the New Zealand legislation. If this does not occur, the "best practice" approach provided in the OECD's final report on BEPS, (Action 4 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), of an EBITDA based ratio should be adopted.

I agree to Inland Revenue contacting me to discuss the above brief submission if required.

Yours faithfully

Richard Smyth
Deputy Chief Financial Officer

Australian Government
Australian Taxation Office

Revaluing assets

Assets can be revalued for thin capitalisation purposes, provided the revaluation is done in accordance with accounting standards, even if they are not also revalued for accounting purposes.

Once an asset is revalued, the asset must continue to be revalued in accordance with the frequency set out in the accounting standards. If the entity does not continue to revalue in accordance with the accounting standards, then it cannot use the original revaluation for the period that it fails to comply with the accounting standards in this regard. It must use the value specified in its financial statements.

If the revaluation is done for the purposes of calculating the entity's thin capitalisation position and is reflected in its financial statements that it is required by Australian law to prepare, the revaluation does not need to be done by either an external expert or an internal expert. However, if either the entity is not required to prepare financial statements or it is required to but the revaluation is not reflected in those statements, the revaluation must be done by either an external expert or by an internal expert.

External expert

An independent expert is a person:

- who is an expert in relation to valuations of that class of assets, and
- whose pecuniary or other interests could not reasonably be regarded as being capable of affecting that person's ability to give an unbiased opinion in relation to that valuation.

Internal expert

An internal expert must be a person who is an expert in valuing such assets, and

- whose pecuniary or other interests could reasonably be regarded as affecting the person's ability to give an unbiased opinion but only because the person would be one of the following
  - performing duties as an employee of the entity
  - providing services to the entity under an arrangement with the entity that is substantially similar to a contract of employment.

To be an acceptable value, the internal expert must make the revaluation in accordance with a methodology that has been reviewed and accepted as suitable by an external expert – see criteria above. The review of the methodology by the external expert must include the validity of any assumptions made, and the accuracy and reliability of the data and other information to be used.

Revaluing an asset in a class of assets

The values used for thin capitalisation purposes are the values calculated under the accounting standards. If the accounting standards require an asset to be revalued at certain intervals, the entity must comply with this for thin capitalisation purposes as well.

A strict adherence to this would require that once an asset in a class is revalued, all the assets in that class must be revalued. The thin capitalisation rules will allow an entity to revalue one or more assets in the class only, provided that no asset in the class of assets has fallen in value.

Example 8: Revaluing assets

Two assets in the same class – asset A and B – have a carrying value of $1,000 and $2,000 respectively. The entity wants to revalue asset A but not asset B. In the relevant income year, asset A has increased in value to $1,200 and the value of asset B has remained the same.

Because, as a class, no asset has fallen in value, asset A can be revalued without having to also revalue asset B. However, if the value of asset B had fallen to $800, asset A could not be revalued without asset B also being revalued.

See also:

- section 820-680 (/law/view/document?docid=PAC/19970038/820-680) of the ITAA 1997.

Revaluation records

An entity must keep records in relation to the revaluation containing details about all of the following:

- the methodology used in making the revaluation, including any assumptions that may have been made
- how the methodology was applied, including information used
- who made the revaluation, their qualifications and their experience as an expert in valuing assets of the relevant kind
- the remuneration and expenses paid to that person.

Where the revaluation was made by the internal expert, the records must **also** include the following details:

- who the external expert was that reviewed the methodology for the valuation
- the external expert's qualifications and experience as an expert in valuing assets of the relevant kind
- the remuneration and expenses paid to the external expert
- the external expert's review of the methodology and their agreement that the methodology is suitable.

All records must be prepared by the time the entity must lodge its tax return for the income year for which the revaluation is made.

However records need not be kept where the asset was revalued subject to subsection 820-680(2A) of the ITAA 1997.

See also:

- section 820-985 (/law/view/document?docid=pac/19970038/820-985) of the ITAA 1997.

Last modified: 09 Mar 2016 QC 48208

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Some of the information on this website applies to a specific financial year. This is clearly marked. Make sure you have the information for the right year before making decisions based on that information.

If you feel that our information does not fully cover your circumstances, or you are unsure how it applies to you, contact us or seek professional advice.

820-680(1)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(1)&db=HISTFT&stylesheet=HIST)

For the purposes of this Division, an entity must comply with the *accounting standards in determining what are its assets and liabilities and in calculating:

(a) the value of its assets (including revaluing its assets for the purposes of that calculation); and

(b) the value of its liabilities (including its *debt capital); and

(c) the value of its *equity capital.

Note:

This requirement to comply with the accounting standards is modified in certain cases (see sections 820-310 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-310#PAC/19970038/820-310) , 820-682 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-682#PAC/19970038/820-682) , 820-683 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-683#PAC/19970038/820-683) and 820-684 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-684#PAC/19970038/820-684)).

View history note

820-680(1A)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(1A)&db=HISTFT&stylesheet=HIST)

In particular, for the purposes of this Division, the entity has an asset or liability at a particular time if, and only if, according to the *accounting standards, the asset or liability can or must be recognised at that time.

Note:

This application of the accounting standards is modified in certain cases (see sections 820-682 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-682#PAC/19970038/820-682) and 820-683 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-683#PAC/19970038/820-683)).

View history note

Requirements for revaluation of assets

820-680(2)

A revaluation of assets mentioned in paragraph (1)(a) must be made by a person:

(a) who is an expert in valuing such assets; and

(b) whose pecuniary or other interests could not reasonably be regarded as being capable of affecting the person ' s ability to give an unbiased opinion in relation to that revaluation.

Note 1:

The entity must also keep records in accordance with section 820-985 (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-985#PAC/19970038/820-985) about the revaluation, unless the exception in subsection (2A) of this section applies.

Note 2:

This subsection also applies to some revaluations that are not allowed by the accounting standards (see subsection 820-684(5) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-684(5)#PAC/19970038/820-684(5))).

View history note

Revaluation reflected in statutory financial statements for the same period

820-680(2A)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2A)&db=HISTFT&stylesheet=HIST)

A revaluation of an asset need not comply with subsection (2) if:

(a) the revaluation is for the purpose of the entity calculating the value of its assets for the purposes of this Division as applying to the entity for a particular period; and

(b) the entity is required by an Australian law to prepare financial statements for a period that is or includes all or part of that period; and

(c) those financial statements reflect the revaluation.

View history note

External validation of a revaluation made internally

820-680(2B)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2B)&db=HISTFT&stylesheet=HIST)

A revaluation of assets mentioned in paragraph (1)(a) may be made by a person (the ***internal expert***) if:

(a) apart from this subsection, paragraph (2)(b) would prevent the internal expert from making the revaluation, but only because, in making it, he or she would be:

(i) performing duties as an employee of the entity; or

(ii) providing services under an *arrangement with the entity that is substantially similar to a contract of employment; and

(b) another person (the ***external expert***):

(i) is not prevented by subsection (2) from making the revaluation; and

(ii) has reviewed the methodology for making it (including the validity of any assumptions to be made, and the accuracy and reliability of the data and other information to be used); and

(iii) has agreed that that methodology is suitable for making it; and

(c) the internal expert makes the revaluation in accordance with that methodology.

Note:

This subsection also applies to some revaluations that are not allowed by the accounting standards (see subsection 820-684(5) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-684(5)#PAC/19970038/820-684(5))).

View history note

Revaluation of individual assets

820-680(2C)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2C)&db=HISTFT&stylesheet=HIST)

Subsection (1) does not prevent the entity from revaluing one or more assets in a class of assets (as distinct from revaluing all the assets in the class) if the value of no asset in that class has fallen since the entity last calculated the total value of all the assets in that class in accordance with the *accounting standards.

View history note

When further revaluation of assets required

820-680(2D)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2D)&db=HISTFT&stylesheet=HIST)

If:

(a) the entity revalues one or more assets (whether constituting a class of assets or not) for the purpose of calculating the value of its assets for the purposes of this Division as applying to the entity for a particular period (the ***first period***); and

(b) the revaluation is *not* required by the *accounting standards; and

(c) if the revaluation *had* been required by the accounting standards, the entity could have relied on it in preparing financial statements that the entity is required by an Australian law to prepare for a period (the ***later period***) that ends *after* the first period;

the entity may also rely on the revaluation in calculating the value of its assets for the purposes of this Division as applying to the entity for a period that is or includes all or part of the later period.

View history note

820-680(2E)

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-680(2E)&db=HISTFT&stylesheet=HIST)

If subsection (2D) does *not* permit the entity to rely on the revaluation in calculating the value of its assets for the purposes of this Division as applying to the entity for a period that is later than the first period, the revaluation is disregarded in determining whether subsection (1) requires the entity to revalue the one or more assets in calculating the value of its assets for those purposes.

> **Note:**
>
> As a result, the entity may not be required to make a further revaluation of the one or more assets. However, if the entity does not, it must use the value of the one or more assets that is reflected in financial statements for the relevant period that comply with the accounting standards.

View history note

Accounting standards need not otherwise apply to the entity

820-680(3)

Subsection (1) has effect whether the *accounting standard would otherwise apply to the entity or not.

View history note

SECTION 820-682 Recognition of assets and liabilities - modifying application of accounting standards

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-682&db=HISTFT&stylesheet=HIST)

Deferred tax assets and deferred tax liabilities

820-682(1)

Despite subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) , an entity must not recognise:

(a) a deferred tax liability (within the meaning of the *accounting standards) as a liability for the purposes of this Division; or

(b) a deferred tax asset (within the meaning of the accounting standards) as an asset for the purposes of this Division.

Note:

Subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) require compliance with accounting standards.

Surpluses and deficits in defined benefit superannuation plans

820-682(2)

Despite subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) , an entity must not recognise an amount relating to a defined benefit plan (within the meaning of the *accounting standards) as:

(a) a liability for the purposes of this Division; or

(b) an asset for the purposes of this Division.

Note:

Subsections 820-680(1) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1)#PAC/19970038/820-680(1)) and (1A) (/law/view/fulldocument?filename=PAC19970038&docid=PAC/19970038/820-680(1A)#PAC/19970038/820-680(1A)) require compliance with accounting standards.

Australian Government
Australian Taxation Office

INCOME TAX ASSESSMENT ACT 1997

CHAPTER 4 - INTERNATIONAL ASPECTS OF INCOME TAX

View history reference (/law/view/document?LocID=PAC%2F19970038%2FCh4&db=HISTFT&stylesheet=HIST)

View history note

PART 4-5 - GENERAL

View history reference (/law/view/document?LocID=PAC%2F19970038%2FPt4-5&db=HISTFT&stylesheet=HIST)

View history note

Division 820 - Thin capitalisation rules

View history reference (/law/view/document?LocID=PAC%2F19970038%2FDiv820&db=HISTFT&stylesheet=HIST)

View history note

Subdivision 820-G - Calculating the average values

View history note

Special rules about values and valuation

SECTION 820-683 Recognition of internally generated intangible items - modifying application of accounting standards

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-683&db=HISTFT&stylesheet=HIST)

Accounting standards prevent recognition of some items

820-683(1)

Subsection (2) applies in relation to an item, other than internally generated goodwill (within the meaning of *accounting standard AASB 138), if:

(a) the item cannot be recognised under that standard as an internally generated intangible asset (within the meaning of that standard) because that standard determines that the cost of the item cannot be distinguished from the cost of developing the entity's business as a whole; and

(b) the item would otherwise meet criteria under that standard for recognition as such an asset.

Note 1:

As a general rule, an entity must comply with the accounting standards when recognising its assets for the purposes of this Division (see subsections 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22) and (1A) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1A)%22)).

Note 2:

This section does not apply to ADIs (see subsection (6)).

Entity may choose to recognise the item as an intangible asset

820-683(2)
Despite subsections 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22) and (1A) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1A)%22), the entity may choose to recognise the item as such an asset for a period for the purposes of this Division (other than section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22)).

Note:

Section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22) is about records for Australian permanent establishments.

820-683(3)
A choice under subsection (2):

(a) must be in writing and may cover more than one item; and

(b) must be made before the due day for lodging the entity's *income tax return for the income year that is, or that includes, the period; and

(c) subject to subsection (4), has effect, for the entity and the item, for the period and each later period.

820-683(4)
The entity may, in writing, revoke a choice under subsection (2). The revocation has effect:

(a) for each period in the income year for which the entity is next required to lodge an *income tax return; and

(b) for each later period.

820-683(5)
When:

(a) recognising an item as an asset under this section; and

(b) calculating the value of the asset (including revaluing the asset);

the entity must, to the maximum extent possible, comply with the *accounting standards as if the recognition were allowed by those standards. This subsection has effect subject to section 820-684 (/law/view/document?LocID=%22PAC%2F19970038%2F820-684%22).

> **Note:**
>
> Section 820-684 (/law/view/document?LocID=%22PAC%2F19970038%2F820-684%22) will allow the entity to revalue the asset even if accounting standard AASB 138 would prevent this because of the absence of an active market.

Choice not available to ADIs

820-683(6)
An entity cannot make a choice under subsection (2) for a period if, for the period, the entity is an *outward investing entity (ADI) or an *inward investing entity (ADI).

View history note

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INCOME TAX ASSESSMENT ACT 1997

CHAPTER 4 - INTERNATIONAL ASPECTS OF INCOME TAX

View history reference (/law/view/document?LocID=PAC%2F19970038%2FCh4&db=HISTFT&stylesheet=HIST)

View history note

PART 4-5 - GENERAL

View history reference (/law/view/document?LocID=PAC%2F19970038%2FPt4-5&db=HISTFT&stylesheet=HIST)

View history note

Division 820 - Thin capitalisation rules

View history reference (/law/view/document?LocID=PAC%2F19970038%2FDiv820&db=HISTFT&stylesheet=HIST)

View history note

Subdivision 820-G - Calculating the average values

View history note

Special rules about values and valuation

SECTION 820-684 Valuation of intangible assets if no active market - modifying application of accounting standards

View history reference (/law/view/document?LocID=PAC%2F19970038%2F820-684&db=HISTFT&stylesheet=HIST)

Accounting standards prevent revaluation of some assets

820-684(1)

Subsection (2) applies if complying with *accounting standard AASB 138 would prevent an entity from revaluing an intangible asset (within the meaning of that standard) because of the absence of an active market (within the meaning of that standard).

Note 1:

As a general rule, an entity must comply with the accounting standards when revaluing its assets for the purposes of this Division (see subsection 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22)).

Note 2:

This section does not apply to ADIs (see subsection (7)).

Entity may choose to revalue the asset

820-684(2)

Despite subsection 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22), the entity may choose to revalue the asset for a period for the purposes of this Division (other than section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22)).

Note:

Section 820-960 (/law/view/document?LocID=%22PAC%2F19970038%2F820-960%22) is about records for Australian permanent establishments.

820-684(3)

A choice under subsection (2):

(a) must be in writing and may cover more than one asset; and

(b) must be made before the due day for lodging the entity's *income tax return for the income year that is, or that includes, the period; and

(c) subject to subsection (4), has effect, for the entity and the item, for the period and each later period.

820-684(4)

The entity may, in writing, revoke a choice under subsection (2). The revocation has effect:

(a) for each period in the income year for which the entity is next required to lodge an *income tax return; and

(b) for each later period. **Requirements for such revaluations**

820-684(5)

Subsections 820-680(2) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2)%22) and (2B) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2B)%22) apply in relation to a revaluation under subsection (2) in a corresponding way to the way they apply in relation to a revaluation mentioned in paragraph 820-680(1)(a) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22).

Note 1:

Subsections 820-680(2) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2)%22) and (2B) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(2B)%22) set out requirements and other matters in relation to revaluations under subsection 820-680(1) (/law/view/document?LocID=%22PAC%2F19970038%2F820-680(1)%22).

Note 2:

The entity must also keep records in accordance with section 820-985 (/law/view/document?LocID=%22PAC%2F19970038%2F820-985%22) about the revaluation.

820-684(6)

When revaluing an asset under subsection (2), the entity must, to the maximum extent possible, comply with the *accounting standards as if the revaluation were allowed by those standards. **Choice not available to ADIs**

820-684(7)

An entity cannot make a choice under subsection (2) for a period if, for the period, the entity is an *outward investing entity (ADI) or an *inward investing entity (ADI).

⊞ View history note

OXFAM
New Zealand

Deputy Commissioner Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

Taxation of Multinationals - Discussion Documents

Dear Madam,

Oxfam welcomes positive steps by this Government to address the unfair situation where the world's richest and most powerful companies and people are avoiding paying their fair share of tax. Tax is key to making sure everyone has vital public services. It is an essential tool to ending extreme inequality, and could help lift millions of people out of poverty. It is estimated that poor countries are losing at least $170 billion every year because of tax avoidance - this is more than the total amount that these same countries are receiving in aid. When taxation works fairly, the majority benefit.

New Zealand could be missing out on up to $500 million a year in tax from multinational companies - money that could be spent on health, education and housing. On a broad level we support the proposals in the documents however we are concerned that **they do not go far enough;**

- in ensuring that New Zealand receives its fair share of tax from multinationals operating in New Zealand
- in committing New Zealand to collaborate on issues of greater transparency around tax practices globally.

Our comments on proposed rules and recommendations are below.

BEPS - Transfer Pricing and Permanent Establishment Avoidance

Oxfam has long been concerned about multinationals not paying tax in the countries they operate in and trade with as it deprives the host countries of tax revenues to spend on desperately needed social services for the local populations.

Diverted profits tax

To that end Oxfam has been supportive of and has called for a Diverted Profits Tax to counter such behaviour. We are supportive of the government's moves to bring in an equivalent measure. We note however that the tests suggested include a consideration of whether the structure is contrary to the purpose of the respective double tax agreement.

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Recommendation: Oxfam recommends that the proposed diverted profits tax equivalent does not reference any double tax agreement but focus simply on the other objective tests.

- a non-resident supplies goods or services to a person in New Zealand;
- a related entity (either associated or commercially dependant) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about;
- some or all of the sales income is not attributed to a New Zealand permanent establishment of the non-resident;

Recommendation: Oxfam recommends that New Zealand's double tax agreements are reviewed to ensure New Zealand can receive its fair share of tax revenue from multinationals and if favourable renegotiation is not possible then the double tax agreements should be rescinded.

BEPS - Interest Limitation Rules

Interest deductions

Oxfam notes that the government has chosen not to implement the earnings stripping rules recommended by the OECD. We are comfortable with this only if the government can assure the people of New Zealand that what it is proposing is equally effective.

On that basis we support the proposals in this document as interest deductions are a very straightforward way of reducing profit by multinationals. For this reason we particularly support:

- The removal of non-debt liabilities from the assets component of the debt to assets test. Such a move will level the playing field between multinationals that would commercially use debt to fund fixed assets and those that wouldn't. For this reason Oxfam strongly supports this move.

- The other proposal we particularly support is the removal of the 10% related party debt allowance for conglomerates including Public Private Partnerships (PPP). Currently PPPs are allowed to deduct all unrelated party debt plus 10% of their related party debt. As related party debt is a "profit stripping" device Oxfam does not see the logic of this and we are pleased to see the proposal to remove it.

Excessive interest rates

Oxfam is aware of the current loophole where high levels of debt can feed into a high interest rate for transfer pricing purposes. We therefore support the intent of the proposals to eliminate this. We note that the proposals are to:

- apply the credit rating of senior unsecured debt for multinationals with an identifiable parent;

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- assess the level of arms-length debt and then the applicable interest rate when there is not an identifiable parent.

It is the second option that causes us concern. Multinationals without an identifiable parent include Private Equity (who are known to take a tax aggressive approach to investment). To find a comparable level of arms-length debt our understanding is that you need to find the debt level of a comparable New Zealand owned firm. Given the high levels of foreign ownership in all our major industries, Oxfam would question whether identifying such a comparable firm was possible. We note that even iconic New Zealand firms such as Spark and Fletcher Building have significant levels of foreign ownership. Even in industries that still have some level of New Zealand ownership such a move will incentivise full foreign ownership so that high levels of interest deduction can become the norm.

Recommendation: It is not our first preference to require all related party interest to be disallowed but if these are the only options available, they have to be taken to ensure entities such as Private Equity pay their fair share of tax. We suggest that if related party interest disallowance is considered excessive; earning stripping rules must be reconsidered for this group.

Omissions on current proposed rules

Global collaboration on tax

Oxfam is an international development agency and our mission is to eliminate poverty globally. We see progressive tax systems (spent progressively) as one of the levers to be able to achieve this goal. While there is a lot that governments can and are doing on their own to improve the progressiveness of their tax systems, such as this consultation on tax policy in New Zealand, there is a limit to what countries can do unilaterally.

Earlier this year, Oxfam released a report that revealed that 8 men own the same wealth as 3.6 billion people who make up the poorest half of humanity. Tax havens are part of this problem. In order to end poverty and inequality; we have to end tax avoidance globally.

Recommendation: Oxfam is calling on all countries to allow for greater collaboration on taxation. A fair and level playing field on corporate tax requires transparency measures, including full public country by country reporting, transparency on beneficial owners and transparency by governments on the tax incentives they grant and in particular on tax rulings.

Non-resident finance companies

Another omission is any move to apply specific interest limitation rules to non-resident finance companies. The issue is they currently only have the on-lending concession apply to them meaning they can have unlimited and unconstrained interest deductions (as was the case with the Australian banks before the specific bank rules were implemented).

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We understand that there is currently not a high level of non-resident finance companies operating in New Zealand. Oxfam accepts that this may be currently the case but this can change very quickly (as was the situation with the banks).

Recommendation: While all the other measures are correcting issues that have been in place for some time, we suggest that it would be preferable to fix identified issues before they become a 'significant drag' on the tax base thereby affecting the government's ability to provide social services.

Oxfam welcomes these consultation documents and we recognise that this a positive first step to ensure multinational companies pay their fair share of tax from profits earned in New Zealand. As stated above we do strongly recommend the inclusion of policies that promote greater collaboration on tax globally to tackle the growing issue of inequality.

Oxfam wishes to acknowledge the significant assistance provided by Andrea Black, adviser to Oxfam, in the research and analysis of the Tax Consultation Documents. Oxfam also greatly appreciates the access to your officials and the open and insightful discussions they had with Andrea Black.

We would be happy to discuss any of these points in more detail. Please contact Paula Feehan-Advocacy and Campaigns Director at paula.feehan@oxfam.org.nz.

Yours sincerely,

Rachael Le Mesurier
Executive Director
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18 April 2017

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policy.webmaster@ird.govt.nz - "BEPS – Interest limitation rules"

Dear Cath

BEPS – Interest Limitation Rules - Proposals to the Interest Rate on Related Party Loans

We are intending to submit on the proposals in Chapter 3 of the Discussion Document March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document).

The date for a submission is 18th April but we seek an extension until 28th April along the lines of this summary of the submission.

Our central submission is that given the development of transfer pricing since it was introduced into New Zealand law and given the recent changes to the rules and guidelines that New Zealand has separately proposed to adopt, the problem of excessive interest rates identified by the Discussion Document should be addressed through the normal application of transfer pricing methodology. There are clear inconsistencies in the outcomes from the Discussion Document proposal and the outcomes that would result from applying transfer pricing rules – applying an arm's length test for the terms and conditions of related party loans.

We consider that the proposed interest rate cap would not be consistent with our double tax agreements, contrary to the view advanced in the Discussion Document.

Perhaps of even greater importance, New Zealand's economic growth strategy requires considerable foreign investment to grow our wealth and incomes. For that reason for many years our

international tax policy has recognised the need to balance potential revenue collection from foreign investors with the need to do so in a way that is not overly adverse in attracting such investment and that would not flow through to a general increase in the economy's cost of capital. The appropriate policy balance seems best achieved by continuing to apply the internationally accepted arm's length principle to deductible interest (based also on loan terms and conditions that are arm's length and a capital structure that is arm's length.)

As we interpret it, the essence of the OECD BEPS project is for countries to co-ordinate approaches to the risks and problems identified with the taxation of international capital flows. The proposed formulaic interest rate cap approach is the direct opposite of such a co-operative approach to international tax policy. In effect it seems to abandon the long-standing internationally accepted arm's length approach with a formulaic approach unique to New Zealand that would be inconsistent in many cases with an arm's length approach.

Failure by New Zealand to keep within the ambit of the arm's length principle with respect to deductible interest costs would mean that foreign investors into New Zealand would not have the protection that compliance with the arm's length principle has in terms of settling disputes between New Zealand and an overseas jurisdiction (mutual agreement by competent authorities - including advanced pricing agreements, and, if provided for, arbitration of disputes between jurisdictions, - and corresponding pricing adjustments). Since most other countries would require interest to be set by the lender on an arm's length basis, which is likely in many cases to be higher than the rate set by the proposed formulaic approach, the result must inevitably be widespread double taxation of New Zealand investments. Thus by moving outside the arm's length framework, New Zealand would introduce tax rules that would impose higher capital costs and risks to investors. There could also be wider reputational risks to New Zealand with any such attempt to jettison the accepted international approach to levying taxation.

There would seem to be a need for a very strong policy reason for New Zealand adopting a policy which unilaterally withdraws New Zealand from these rules for settling jurisdictional disputes. We submit that the Discussion Document does not provide such a justification.

We also disagree with the suggestion in the Discussion Document that loans for a term exceeding 5 years are inherently uncommercial and not to be considered to be issued on arm's length terms. What is an arm's length term of a loan will vary depending on the circumstances of the business and the loan.

Given the complexities for taxpayers and IRD of applying transfer pricing rules we submit that there should be safe harbour rules where the terms and conditions of related party loans should be legislatively accepted as meeting an arm's length test. The government should be confident that the revenue base is not at risk where commercial constraints operate as to require loan terms and conditions to be arm's length.

In that regard if a taxpayer is within the existing thin capitalisation thresholds (60% assets, 110% worldwide gearing) the interest rate should be accepted. It seems unlikely that related party debt

could be “deeply subordinated” so as to enable dividends to be disguised as interest by increasing the level of debt and then deeply subordinating related party debt at such levels of gearing.

It is also submitted that there should be a safe harbour rule from transfer pricing where a New Zealand entities total debt is not materially held proportionately by shareholders and debt instruments with the same terms and conditions are not materially held in proportion to share ownership

We further submit that there should be a further safe harbour form the application of transfer pricing to related party debt where the interest rate is set at no more than the cost of the related party’s cost of funds measured as the cost of senior unsecured debt on standard terms plus a margin as outlined in the Discussion Document. This would, however, be only a safe harbour and taxpayers would be free instead to use another safe harbour (as above) or full transfer pricing methodology.

Finally, we submit that if an interest rate cap is introduced that overrules the arm’s length test for related party loans, existing investments funded by such loans should not be subject to such a cap. That is because investments have been made on the commercial basis that New Zealand would accept loans with arm’s length terms and conditions. That is a reasonable expectation for investor’s to make. To now impose new rules contrary to such expectations would adversely and retrospectively affect investment decisions. That would be contrary to long-standing policy adopted in New Zealand with respect to tax changes with retrospective effect.

Yours faithfully

Yours faithfully
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28 April 2017

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Dear Cath

BEPS – Interest Limitation Rules - Proposals to the Interest Rate on Related Party Loans

This submission is with respect to the proposals in Chapter 3 of the Discussion Document March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document).

We would welcome the opportunity to discuss this submission.

Executive Summary

We have reviewed the proposed limit on the interest rate on related party loans based on an interest rate cap set at the interest rate that the borrower's ultimate parent could borrow on standard terms (defined as the parent's credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin).

Our conclusion and central submission is that given the development of transfer pricing since it was introduced into New Zealand law, and given the recent changes to the rules and guidelines that New Zealand has separately proposed to adopt, the problem of excessive interest rates identified by the

Discussion Document should be addressed through the normal application of transfer pricing methodology. The Discussion Document proposals would produce clear inconsistencies in outcomes from the result that would arise from applying transfer pricing rules. The Discussion Document proposals are, in our view, inconsistent with the originally stated policy objective of thin capitalisation rules which was stated to be "to accurately determine interest expense properly attributable to New Zealand without interfering with normal commercial behaviour, at minimal compliance cost, within the self-assessment system."

The key question is - how can New Zealand justify adjusting an interest rate if the taxpayer can demonstrate that the interest rate is an arm's length price based on an arm's length gearing and with debt issued on arm's length terms and conditions? Disallowing interest deductibility for an arm's length transaction at an arm's length price would:

- Make New Zealand inconsistent with the rest of the world, especially Australia.
- Poorly target interest adjustments beyond the problem identified in the Discussion Document.
- Undermine the ability of high risk/ potentially high return New Zealand investments (especially innovative and new technology enterprises with global potential) to access capital.
- Seem to be contrary to New Zealand's commitments under double tax agreements to apply transfer pricing methodology.
- Raise the prospect of international double taxation.
- Unfairly penalise some firms in an arbitrary manner.

We also consider that there are a number of detailed problems with the Discussion Document proposal. For example, the Discussion Document states that "most firms subject to the thin capitalisation rules are controlled by a single non-resident" parent and then attributes that parent's financing costs to the New Zealand entity. However, many firms with related party cross border lending are not are not controlled by a single parent. Even if our other problems with the proposal did not apply, the only funding cost that could conceivably be relevant is that of a parent that wholly owns the New Zealand entity. Outside that scenario there seem to be substantial practical problems with the Discussion Document proposal.

As we interpret the Discussion Document the policy issue is the perceived need to buttress our existing thin capitalisation rules. We note that this is different from the OECD's recommended EBITDA approach for limiting interest deductibility. The OECD EBITDA approach's stated objective is to reduce what the OECD claims to be a tax preference for debt over equity. In the main we view that as a tax penalty on equity resulting largely from the classical double taxation of company income. The EBITDA can be seen as trying to level the international playing field by trying to impose a tax penalty on an element of interest.

These considerations are not relevant in the New Zealand environment where debt and equity have more equal tax treatment as a result of imputation. Instead the New Zealand focus should be purely on ensuring that our thin capitalisation rules do not allow New Zealand corporate income to be extracted as low-taxed interest in a manner contrary to the intent of our policy settings. We submit

that this is best achieved through transfer pricing methodology with safe harbours to reduce compliance and administrative costs where the tax base risk is low.

In summary, our submission is:

- It is not appropriate to set any interest rate cap on the basis of the interest rate paid by the "borrower's ultimate parent" on its senior unsecured debt. The borrowing costs of the non-resident investor can only technically be relevant when the parent wholly owns or possibly consolidates with the New Zealand entity for accounting purposes.
- The issue of determining the interest expense properly attributable to New Zealand should be determined by existing thin capitalisation rules buttressed by the arm's length rule for determining deductible interest rates.
- The arm's length test should be subject to safe harbour rules. One such safe harbour rule should be that for determining deductible interest rates the actual terms and conditions of related party loans should be acceptable provided the New Zealand entity has gearing within the thin capitalisation maximum gearing ratios (the focus of concern should be in cases where the 60% debt ratio has been exceeded).

Current Thin Cap Rules- Inbound investment

Very broadly, our inbound thin cap rules restrict the debt level of a non-resident controlled corporate group or taxpayer. If the level of debt exceeds prescribed limits, the interest expense of the excess debt is treated as income offsetting the deduction available on such interest. The effect is that interest on the excess debt is non-deductible. The level of debt is treated as excessive if the:

- New Zealand group debt exceeds 60% of total assets; or
- New Zealand group debt exceeds 110% of the debt percentage of the worldwide group.

A person subject to these thin cap rules can choose the option that is most favourable from its point of view.

The inbound thin cap rules apply to a non-resident or a New Zealand entity that is under the control of a single non-resident or that is controlled by a group of entities (including non-residents and entities controlled by non-residents that act together) - for example a joint venture fund that includes non-residents. A New Zealand entity is under the control of a non-resident or group of entities if that non-resident or group has ownership interests of 50% or more or has control by any other means. Ownership interest is the **highest** of shares, voting rights, or rights to distribution (sections FE2 and FE 39 of the Income Tax Act 2007 ("the Act"). In contrast, for transfer pricing and other purposes, a company is associated with another company if it has 50% or more of **voting interests** or, if applicable a market value interest (sections YB2(1) and (2) of the Act).

Policy Objective of Inbound Thin Cap Rules

The policy objective of inbound thin cap rules was stated in the original 1995 Discussion Document (International Tax – A discussion document) to be to "limit the ability of non-resident investors to artificially reduce their net New Zealand-sourced income by allocating excessive interest costs to New Zealand" (page 53). The policy aim was further stated to be: "to accurately determine interest expense properly attributable to New Zealand without interfering with normal commercial behaviour, at minimal compliance cost, within the self-assessment system" (idem).

In effect, thin cap is an anti-abuse rule. Dividends are non-deductible (so that the New Zealand tax rate on the equity investment by a non-resident in a New Zealand company is the company tax rate of 28% plus NRWT on dividends, if any). Interest is deductible so that the New Zealand tax rate on debt finance is limited to the NRWT (or AIL) on interest. The policy concern that underlies thin cap is that debt is substituted for equity so that what would in the absence of tax be taxed as an equity return (28% plus any NRWT) is instead taxed at the much lower rates on interest. At the extreme, a non-resident could invest $1 of equity and repatriate all profits as interest, effectively paying minimal New Zealand tax on the investment. As the 1995 discussion document made clear, concerns with protecting the New Zealand tax base need to be balanced by having a tax system that is attractive to foreign investors given New Zealand dependence on investment from abroad to generate economic growth. Thin cap rules have therefore always been seen from a policy perspective as targeting situations where it could reasonably be concluded that investment was being undertaken by debt that was in substance equity or would have been by way of equity if based on normal commercial considerations.

Proposal

The thin cap rules that were implemented following the 1995 discussion document set maximum debt/equity ratios as outlined above. (The maximum group debt percentage was reduced from 75% to 66% from 2011/12). The 2017 discussion document raises the concern that New Zealand's thin cap rules set maximum debt/equity ratios (the level of debt) but the policy concern is with the level of profits (prior to financing costs) that a non-resident investor can extract by way of lowly taxed interest. In other words, the concern is with the level of interest expense which is a product of the level of debt (constrained by existing thin cap rules) and cost of debt or interest rate (seen by the Discussion Document as not constrained by existing thin cap rules.)

The example is given of a New Zealand company owned by a foreign parent. The New Zealand subsidiary is funded from loans from the parent. The risk of that debt is increased because of the high level of gearing or by its terms and features – examples given are the loan being highly subordinated, repayable on demand, having extremely long terms, or convertible into shares (paragraphs 3.10 and 3.11). It is argued that while this may increase the risk associated with the debt, and thus be used to try to justify high interest rates, this does not alter the overall risk to the parent of the investment. It simply transfers equity risk into debt risk – with the overall risk borne by the foreign investor unchanged.

The 2017 discussion paper proposes as a response to retain New Zealand's current thin cap rules but supplement them by a cap on the level of deductible interest rates.

It is proposed:

- The cap apply to loans from a non-resident to a New Zealand borrower (3.17)

- The loan must be a related party loan defined (3.43) as being when the lender is:
  - a member of the same worldwide group as the borrower
  - a member of a non-resident owning body (a group of 2 or more non-residents who each hold ownership interests in the company)
  - an associated person of the group or body.

- The basic rule proposed is that the interest rate cap is set at the interest rate that the borrower's ultimate parent (the main operating company in the group where the parent is a holding company) could borrow on standard terms (defined as the parent's credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin. - paragraph 3.23). Where there is no ultimate parent (the New Zealand firm is owned by a non-resident owning body), the interest rate that would apply if the New Zealand group raised senior unsecured debt on standard terms with no margin and in determining the rate on such senior unsecured debt basing this on the level of debt under transfer pricing principles or deem all related party debt to be equity for the purposes of determining the New Zealand group's credit worthiness (3.36)

- A related party loan is proposed to be treated as having a term of 5 years for determining the interest rate cap (3.53).

Comment

We accept that the policy objective of thin cap rules is the level of interest deductions. This is determined by not only the level of debt (constrained by current thin cap rules) but also the price of debt (the interest rate). We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent (and carrying on the same business activity as the parent), increasing the risk associated with parent lending may be used to justify a higher interest rate but does not alter the parent's overall investment risk. We can understand the argument why in such a scenario high interest rates can be viewed as being substituting non-deductible dividends for deductible interest. However, we consider that any policy response should be targeted at situations where there is this close substitutability of interest for dividends and should be reasonable in that context. Any policy response should also be consistent with the international tax framework adopted by our trading partners which is based on arm's length terms and prices being applied to related party transactions.

The example in the discussion document is of a foreign parent that has 100% ownership of a New Zealand subsidiary. The implicit assumption is that the parent and subsidiary are in essence operating the same type of business and therefore lenders have a similar risk when lending to either

the parent or the subsidiary. The document argues that if the foreign parent substitutes debt for equity (or introduces features into the debt instrument that increases the debt risk) this does not alter the owner's overall risk in the investment but merely how that risk is allocated between different instruments all of which are owned by the same person. That is an argument for limiting deductible interest rates but only within the scenario where an increase in debt risk is offset by a decrease in equity risk with no change in the actual risk faced by any investor. The discussion document also argues that it makes no difference whether the foreign parent borrows funds and then on-lends them as a related party loan to the subsidiary or whether the subsidiary borrows directly from an unrelated party. This leads to the conclusion that the commercial cost of funds is the parent's interest rate. However, again it is limited to the scenario presented in the discussion document (100% owned subsidiary) and assumes that the parent explicitly or implicitly guarantees the unrelated party debt of the subsidiary.

The discussion document proposals are not well targeted and not reasonable in their context. While we concede that there may be situations outside a 100% commonly owned group, where in substance the same outcome arises, any interest cap based on the parent's cost of borrowing should be limited to situations where, as in the simple example presented in the discussion document, any increase in debt risk can reasonably be viewed as not altering the overall risk assumed by any investor so that the increased interest rate can in substance be viewed as a dividend return on equity.

The issues with the wide ambit of what is proposed in the discussion document can be illustrated by the example of a foreign lender deemed to be a related party lender under the proposals that has only a 51% interest in the New Zealand borrower. The foreign lender is in a different business and has a totally different risk profile to the New Zealand borrower. It may be an institutional investor (a collective investment vehicle) with no gearing itself and a diversified world-wide portfolio of investments of which the New Zealand investment is an immaterial aspect. In the case of a sovereign wealth fund the investor is likely to have an implicit or even explicit government guarantee enabling it to borrow at close to a sovereign risk credit rating. The New Zealand investment may be very high risk – such as petroleum mining or an IT venture. The only related party debt is provided by that foreign lender so that the other (49%) owners of the New Zealand investment do not provide loan finance.

In such a case, it cannot realistically be argued that the correct market interest rate of the New Zealand entity (the interest expense properly attributable to New Zealand without interfering with normal commercial behaviour) is the interest rate the foreign lender would be required to pay on its borrowings. It cannot realistically be argued that the foreign entities debt is substitutable for equity. Finally, it cannot realistically be argued that in providing related party debt the risks assumed by each investor remain the same as if the investment were equity financed. The lender will have a credit rating for senior unsecured debt that reflects its sovereign risk credit rating or at least a very high credit rating given its lack of gearing and diversified investment portfolio. The New Zealand investment entity will have a cost of funds reflecting its much higher risk being a geared undiversified high risk investment. The example may be somewhat of an outlier but illustrates the general point that the discussion document example was a 100% owned subsidiary with the same investment profile as the parent. Outside the parameters of that restricted example, it is clear that

the commercial cost of funds of the New Zealand entity will not necessarily reflect the cost of funds of any single overseas investor in that entity.

The economic costs of unduly restricting the deductibility of the interest costs of New Zealand enterprises are potentially high. It will often be the case that a New Zealand venture with potentially high returns but high risk (such as will biotechnology or IT) need considerable overseas capital to grow especially if high profits are only available by scaling the venture up globally. An ideal foreign investor is often a globally diversified fund (or group of funds) with a high credit rating that is able to undertake risk as a result of its diversified portfolio. The extent of capital injection required means the fund(s) may need to take a controlling equity interest. However, the funds will still want New Zealand investors to keep a substantial equity involvement in order to align incentives. This limits the amount of funds that can be raised by way of equity.

The remaining funding is therefore required to be provided by way of debt. Financial institutions are unlikely to provide such debt funding because of the risk – or if they did so only at very high interest rates. The most obvious source of debt funding is the foreign fund(s). The fund(s) ownership interest means that they have an in-depth and up to date knowledge of the New Zealand investment so that they have a better view than an external financier of the actual debt risk involved. Obviously, however, from a purely commercial perspective the fund(s) will want an interest rate on this related party debt that reflects its actual commercial risk – which is the risk associated with the New Zealand firm which will be considerably higher than the fund(s) cost of debt based on the fund(s) high credit rating. If interest on such related party debt is restricted to the interest rate that the fund(s) could borrow on standard terms (defined as the fund(s)'s credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin), a material part of the commercial interest cost of the New Zealand entity would become non-deductible. Applying the proposals in the discussion document in this way would amount to introducing a tax penalty on high risk/ high growth New Zealand ventures with global potential. That seems clearly contrary to the government's economic growth strategy.

To avoid these economic distortions and to ensure that any limitation of deductible interest is in line with the stated policy objective it is therefore submitted that any such limitation should be consistent with international practice and narrowed to situations closer to the example provided in the discussion document where it is more arguable that related party debt may be viewed as more substitutable for equity and does not affect the investment risk borne by each investor.

The Primary Rule Should be that Interest Rates Should be Governed by Transfer Pricing

Interest is the price paid by the borrower for the use of finance provided by debt funding. The general international rule is that where goods or services are supplied across a border between associated persons, the price for goods or services must be set at an arm's length price being the price that would be agreed upon if the parties to a related party transaction were not associated and acted at arm's length. Since the interest rate is simply a price for the use of money, transfer pricing should apply to cross border interest rates between related parties just as it does for rents for land or machinery between related parties.

When New Zealand introduced its thin capitalisation and transfer pricing rules in 1995, maximum debt levels were set under thin capitalisation and this explicitly excluded the operation of transfer pricing. This was for a number of reasons:

- The policy concern was to set a maximum gearing ratio rather than the price or interest rate.

- The policy was explicitly to include in maximum debt levels debt from unrelated parties if a New Zealand enterprise was foreign controlled. Transfer pricing was seen as restricted to limiting only related party debt.

- Transfer pricing was relatively undeveloped internationally at that time and New Zealand had little background in operating such rules so that transfer pricing alone was seen as inadequate to protect the tax base especially given the limited experience of IRD in operating transfer pricing rules. It is understood there was a concern that since transfer pricing focused on price (the arm's length price) it might not limit the quantum of debt and even if it did so, IRD might not have the technical expertise to manage transfer pricing rules that also covered the level of debt.

Even so, since New Zealand's thin capitalisation rules did not override our double tax agreements ("DTAs") where (principally by way of the article 9 – associated person transactions - and article 24 – non-discrimination) DTAs required interest to be deductible if such interest met the arm's length transfer pricing test, it is understood that New Zealand accepted that the arm's length test overruled the thin capitalisation rules.

The policy environment has changed considerably since 1995.

- The Discussion Document's focus is excessive interest rates not the quantum of debt per se. The level of interest rates (price) is squarely within the ambit of transfer pricing rules governed by internationally agreed guidelines as to its technical application.

- The Discussion Document's focus is (correctly) on the interest rate set with respect to related party loans. The 1995 concerns with the level of debt incurred by a New Zealand enterprise with unrelated parties are not relevant in this context.

- Transfer pricing is now well developed internationally and New Zealand taxpayers and IRD have developed considerable expertise in operating transfer pricing rules. For example, the OECD is now clear that article 9 of the Model Convention (the transfer pricing article) "is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital." (2014 Commentary pages 183-184). The rationale is that transfer pricing rules aim to establish a level of profits from a transaction that corresponds to the profits that would have resulted from an arm's length transaction and, to achieve this, the level of debt as well as the interest rate and the terms and

conditions attaching to a related party loan needs to be on an arm's length basis. It is now clear that transfer pricing under article 9 specifically allows a tax authority to disallow interest deductions to the extent that a related party loan is not provided on an arm's length basis. In other words, it is not clear that the discussion document objective of limiting the extraction of profits by way of excessive interest costs on related party lending can be met within normal transfer pricing rules applying the arm's length principle.

The Discussion Document is, in our view, correct in reaching the view that the policy issue with related party lending is to determine a commercial (arm's length) quantum of interest which, as the Discussion Document notes, is the product of the level of interest rate and the level of debt. In other words, price (interest rate) and quantity (level of gearing) need to be considered from a commercial perspective in an integrated approach. Transfer pricing rules achieve such an outcome and should be the preferred method of dealing with the issues raised in the Discussion Document.

Unlike the proposed arbitrary cap based on the lender's cost of borrowing, transfer pricing accommodates scenarios outside the simple parent lending to subsidiary scenario where both parent and subsidiary undertake similar business/investment activities because transfer pricing can take into account these material differences in situations. Transfer pricing also provides the advantage of consistency with other comparable tax jurisdictions, especially Australia which uses an arm's length pricing approach to determine acceptable interest rates.

New Zealand's economic growth strategy requires considerable foreign investment to grow our wealth and incomes. For that reason for many years our international tax policy has recognised the need to balance potential revenue collection from foreign investors with the need to do so in a way that is not overly adverse in attracting such investment and that would not flow through to a general increase in the economy's cost of capital. The appropriate policy balance seems best achieved by continuing to apply the internationally accepted arm's length principle to deductible interest (based also on loan terms and conditions that are arm's length and a capital structure that is arm's length.)

As we interpret it, the essence of the OECD BEPS project is for countries to co-ordinate approaches to the risks and problems identified with the taxation of international capital flows. The proposed formulaic interest rate cap approach is the direct opposite of such a co-operative approach to international tax policy. In effect, it seems to abandon the long-standing internationally accepted arm's length approach with a formulaic approach unique to New Zealand that would be inconsistent in many cases with an arm's length approach.

Failure by New Zealand to keep within the ambit of the arm's length principle with respect to deductible interest costs would mean that foreign investors into New Zealand would not have the protection that compliance with the arm's length principle has in terms of settling disputes between New Zealand and an overseas jurisdiction (mutual agreement by competent authorities - including advanced pricing agreements, and, if provided for, arbitration of disputes between jurisdictions, - and corresponding pricing adjustments). Since most other countries would require interest to be set by the lender on an arm's length basis, which is likely in many cases to be higher than the rate set by the proposed formulaic approach, the result must inevitably be widespread double taxation of New

Zealand investments. Thus, by moving outside the arm's length framework, New Zealand would introduce tax rules that would impose higher capital costs and risks to investors. There could also be wider reputational risks to New Zealand with any such attempt to jettison the accepted international approach to levying taxation.

There would seem to be a need for a very strong policy reason for New Zealand adopting a policy which unilaterally withdraws New Zealand from these rules for settling jurisdictional disputes. We submit that the Discussion Document does not provide such a justification.

The desirability of using transfer pricing as the prime set of rules to protect the tax base is especially strong given the recent revision to the OECD's transfer pricing guidelines as a result of the BEPS project. In a separate Discussion Document (Transfer pricing and permanent establishment avoidance) released at the same time as the interest limitation discussion document, it is proposed that New Zealand's transfer pricing rules be strengthened so that they are aligned with the OECD transfer pricing guidelines and Australia's transfer pricing rules. In particular, the new rules if implemented will clarify that New Zealand transfer pricing rules can be used to:

- Disregard the legal form of a transaction (a related party loan) to the extent the legal form does not reflect the economic substance of the transaction.

- Allow the legal conditions of a transaction to be replaced by arm's length conditions (or allow the transaction to be disregarded) with respect to transactions that independent parties would not have entered into under those conditions.

This seems to provide IRD with the tools to amend (or disregard) related party loans where it can reasonably be argued that, as per the examples in the Discussion Document, interest on the loans is in substance a dividend. Such interest, if re-characterised under transfer pricing rules, would achieve the non-deductible result that is the policy objective as set out in the Discussion Document. The Discussion Document itself seems to accept that transfer pricing proposals would provide tools to meet the policy objective of the Discussion Document. At page 8 it states:

> "the proposed transfer pricing rules would disregard legal form if it does not align with the actual economic substance of the transaction. They would also allow transactions to be reconstructed or disregarded if such arrangements would not be entered into by third parties operating at arm's length."

In any case, it would seem that our DTAs based on the OECD Convention override any disallowance of interest costs for a non-resident enterprise or New Zealand company paying interest to a non-resident.

Article 9 of the Model Convention provides that where an enterprise has related party transactions not on arm's length terms these can be adjusted by tax authorities to produce a profit that would have accrued to the enterprise if transactions were on an arm's length basis and that profit can be made liable to tax by a jurisdiction. As discussed in the OECD's 1986 "Report on Thin Capitalisation" and in the Commentary to article 9, there have been differences of views as to whether article 9

simply allows a jurisdiction to adjust profits to those arising on an arm's length basis (in which case New Zealand would not be restricted to taxing profits in excess of those that would be calculated on an arm's length basis) or whether the article prohibits countries from calculating and taxing profits in excess of those that would be calculated on an arm's length basis (in which case DTAs based on the Convention would overrule any attempt by New Zealand to impose a deductible interest rate cap not in conformity with the arm's length principle). The OECD's conclusion was that the latter of the above alternatives is the correct way to interpret DTAs. This is reflected in the following statement on page 184 of the 2014 Commentary Update:

> "the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and this principle should be followed in applying existing tax treaties."

New Zealand has not lodged any observations on this aspect of the Commentary.

Article 24 (3) of the Model Convention states that a permanent establishment of a non-resident cannot be less favourably taxed than a New Zealand company carrying on the same activities. Article 24 (4) states that interest paid by a New Zealand company to a non-resident shall be deductible under the same conditions as if it had been paid to a resident of New Zealand. An exception applies if the transfer pricing article (article 9) applies. It is generally accepted that these provisions override thin capitalisation/restrictions on interest deductibility as proposed in the Discussion Document if such rules are inconsistent with the results under transfer pricing. For example, the OECD Commentary on article 24 states that the article:

> "does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible [with transfer pricing rules]. However, if such treatment results from rules which are not compatible with [transfer pricing rules] and which only apply to non-resident [lenders] (to the exclusion of resident [lenders]), then such treatment is prohibited." (2014 Commentary page 367).

The Discussion Document argues that its proposed cap on interest deductibility where the lender is non-resident would be consistent with our DTAs on the following bases:

- As noted above, the OECD Commentary states that thin capitalisation rules are consistent with the arm's length principle to the extent the profit that results would have accrued in an arm's length situation (para 3.57). As noted above in the simple parent/subsidiary example where both operate similar businesses it may be that the parent's cost of funds could be used to determine the subsidiaries cost of funds, but this does not apply to other arrangements where the Discussion Document approach seems to produce a result not in accordance with transfer pricing and the arm's length principle. If the Discussion Document did produce an arm's length approach it would then be more logical and clearer for New Zealand to adopt the arm's length approach to related party interest rates.

- The Discussion Document proposal would be a domestic anti-avoidance provision and there can be no conflict between domestic anti-avoidance provisions and DTAs (para 3.59). This seems to suggest that a country can label any provision of domestic law "anti avoidance" on the basis it is expected to raise revenue that might not otherwise be raised and then ignore its DTAs. The end result would be that DTAs would be ineffective in limiting double taxation or protecting taxpayers. The OECD Commentary warns that "it should not be lightly assumed that a taxpayer is entering into . . . abusive transactions" (2014 Commentary page 63). Anti abuse provisions are consistent with DTAs only to the extent that they counter transactions that are contrary the object and purpose of the DTA provisions. The object and purpose of the OECD Model Convention is clearly to apply the arm's length principle to cross-border related party transactions. A domestic law provision that prevented the application of the arm's length principle would be contrary to the object and purpose of DTAs and such a provision cannot be justified on the basis that it does the opposite.

- The Discussion Document argues that the OECD has recommended an EBITDA based interest limitation rule and thus the Discussion Document approach must be consistent with international practice and the OECD's recommendations. Clearly the Discussion Document approach is not consistent with international practice being unique in the world. As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". Whether or not it is seen as equivalent to what OECD recommends is not determinative of whether or not the approach would be overridden by a DTA. In any case the OECD EBITDA approach explicitly does not limit interest deductions to situations where the lender is non-resident. Instead the OECD recommends that the EBITDA approach apply **at a minimum** to all entities that are part of any multinational group but the OECD also suggests it could usefully apply to all entities including stand alone companies with purely domestic operations (OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – 2016 Update page 37). The inconsistency with the provisions of the DTA thus does not arise with the OECD proposal. They do, however, arise with the Discussion Document proposal.

It is submitted that if the arm's length test is our primary rule for limiting the deductibility of related party cross border interest rates because of our DTAs it should, even without the other advantages noted above, be our primary provision under domestic law.

The Discussion Document discusses and rejects the transfer pricing approach because "the highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply" (para 3.13). If compliance costs are a concern it is difficult to reconcile that with the proposed de minimis rule that those with related party loans less than $10 million be required to use "ordinary transfer pricing rules" (para 3.48). Further, this raises the viability of transfer pricing rules more generally. Again we see no basis for this assertion and we believe the transfer pricing rules are robust.

Admittedly transfer pricing rules can in some circumstances be complex but that is not being advanced as a reason not to apply them across all other prices other than interest. The normal response to such complexity is a set of safe harbour rules – which we support. Australia applies

transfer pricing to limit related party cross border interest rates and in doing so can adjust such rates in accordance with identified uncommercial terms along the lines set out in the Discussion Document - the loan being highly subordinated, repayable on demand, having extremely long terms, convertible into shares.

The Australian thin capitalisation rules, including using an arm's length approach for setting maximum debt levels, were recently subject to a comprehensive review by the Australian Board of Taxation – Review of the Thin Capitalisation Arm's Length Debt Test December 2014. This concluded that the arm's length test is the "central plank of the thin capitalisation rules" (page 5). It is supported by safe harbour rules which "the vast majority of taxpayers affected by the thin capitalisation rules can operate within" (page 5). This manages the complexity issue raised by our Discussion Document. The review supported retention of the arm's length test noting that "Stakeholders, including the ATO, universally supported retaining [the arm's length test] indicating that the test should be available to all taxpayers" (page 25). Mainly administrative measures were recommended to improve the operation of the rules (largely an improved risk framework for better identifying risks). The Australian experience, and the ATO's endorsement of the use of the arm's length principle, suggests that the Discussion Document's stated concern with the risk to the tax base from using an arm's length approach (para 3.13) is unfounded. Complexity can be managed by adopting appropriate safe harbour rules.

The Discussion Document (at page 10) cites the OECD Report on Interest Limitation Rules as supporting the view that the arm's length test has not proven to be adequate to deal with the issue of profits being extracted at a low rate of tax by way of excessive interest costs. The OECD Report (2016 Update page 24) notes that the arm's length test "requires a consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed" and that this has the advantage in that "it recognises that entities may have different levels of interest expense depending on their circumstances." However, the Report argues that the arm's length test may not be sufficient to deal with all BEPS issues. It notes, for example, "an arm's length test does not prevent an entity from claiming a deduction for interest expenses which is used to fund investments in non-taxable assets or income streams". Instead the Report supports the EBITDA approach (complementing the arm's length test). The EBITDA approach is recommended to apply at a minimum to all MNEs – not just international transactions. That is because, while the stated objective of the Discussion Document is to buttress our existing thin capitalisation rules, the OECD Report has a wider BEPS focus. Since the OECD Report supports the arm's length test as a complement to its wider EBITDA approach, it is not appropriate to consider the OECD Report as evidencing a rejection of the arm's length approach.

Finally, it is noted that adjusting interest deductions within the transfer pricing framework has the very significant advantage of incorporating measures to reduce the risk of double international taxation. For example, New Zealand denies an interest deduction to a parent and in effect treats part of the interest as a non-deductible dividend. The parent company is taxed on interest but not dividends. The parent company jurisdiction still recognises the full payment as taxable interest whereas New Zealand in effect treats part of the payment as a dividend which would be tax exempt under the laws of the parent company jurisdiction. If the New Zealand adjustment to interest deductibility is made under transfer pricing rules then under paragraph 2 of Article 9 of the Model

convention a corresponding adjustment is required by the parent company jurisdiction so as to avoid double taxation. No such adjustment seems possible under the approach proposed in the Discussion Document. Nor, outside the arm's length test, are the other OECD convention protections for taxpayers such as the mutual agreement procedure (and possibly arbitration) and Advanced Pricing Agreements with other jurisdictions available.

Transfer Pricing Buttressed by Existing Deemed Dividend Rules

There may be a concern that the ambit of transfer pricing rules may be too narrow to cover all situations in which there could be a base concern. However, it needs to be appreciated that with respect to interest rates paid to shareholder lenders, interest over a commercial rate (excessive interest) is likely to be a dividend under current law (section CD 5). The company provides money to the shareholder/lender (interest) and this exceeds more than the market value of what the shareholder provides because the interest rate exceeds the market rate.

Safe Harbour Rules

As previously noted, the complexity for taxpayers and IRD of applying transfer pricing may justify safe harbour rules. In all cases (except possibly de minimis), all related party interest should be at reasonably arm's length or market rates given the risk profile of the borrower, and the terms and conditions of the actual loan.

Existing thresholds for debt levels

If a taxpayer is within the existing thin capitalisation thresholds (60% assets, 110% worldwide gearing) the interest rate should be accepted. It seems unlikely that related party debt could be "deeply subordinated" so as to enable dividends to be disguised as interest by increasing the level of debt and then deeply subordinating related party debt at such levels of gearing.

There still may be a concern that related party debt can be issued with repayment terms or convertibility that is used to justify an excessive interest rate. Consideration could be given to allow IRD to adjust deductible interest rates to reflect a rate that would apply without such special terms. That could for example be the rate paid on unrelated party debt.

We do, however, disagree with the suggestion in the Discussion Document that loans for a term exceeding 5 years are inherently uncommercial and not to be considered to be issued on arm's length terms. What is an arm's length term of a loan will vary depending on the circumstances of the business and the loan. It seems difficult to argue that arm's length loans should be limited to 5 years when mortgages over land are commonly provided between unrelated parties for terms of 20 or 30 years. It is likely that a long term low risk investment (such as an infrastructure project) would commercially, and on an arm's length basis, have terms exceeding 5 years.

Interest rates based on the related party's costs of funds.

We submit that there could be a further safe harbour form the application of transfer pricing to related party debt where the interest rate is set at no more than the cost of the related party's cost of funds measured as the cost of senior unsecured debt on standard terms plus a margin as outlined in the Discussion Document. This would, however be only a safe harbour and taxpayers would be free instead to use another safe harbour (as above) or full transfer pricing methodology.

It would seem useful to provide such a safe harbour where a related party is lending funds and the interest rate is such that there is no realistic chance of the interest rate being higher than would be the arm's length rate applying full transfer pricing methodology.

Grandparenting

The Discussion Document proposes that once the proposed interest limitation rule is legislated for it should take effect and apply to related party cross border financial arrangements currently under foot.

We submit that if an interest rate cap is introduced that overrules the arm's length test for related party loans, existing investments funded by such loans should not be subject to such a cap. We submit that not grandparenting existing loans in this way would be contrary to stated policy on prospective and retrospective tax law changes and grandparenting.

The policy positon in this area was set out in the October 2003 paper by the then Deputy Commissioner (Policy) – Taking a Fixed Tax Positon in a Changing World. The paper notes that tax changes often impact on decisions and investments made prior to the legislative amendment taking effect. There are economic and justice/fairness benefits in providing taxpayers with certainty as to how tax law impacts on them but this needs to be balanced by the ongoing need to amend the tax legislation. The conclusion reached (at page 13) is:

> "It is legislated changes in expectations that really matter, not just changes in the legal words. Protecting expectations is seen as the best way of balancing the social and economic benefits of legal certainty with the social and economic costs of living with fixed law."

The paper goes on to state (at page 18):

> "As a general rule the government will propose prospective legislation. Such legislation can, however, still affect existing transactions especially if there is no grandparenting provisions. . . . officials will recommend legislation with pre-enactment effect, when this seems to be the best way to maintain the rational and reasonable expectations of the operation of the law."

In effect, the paper concludes that people should expect some forms of tax changes and that such changes will impact (adversely or positively) on past decisions and investments. However, where people have a rational and legitimate expectation that the law will not change – it can objectively be said that a tax law change would surprise a reasonable person – then a person should be protected from tax law changes by way of grandparenting provisions.

As outlined above the arm's length principle is a well established principle for adjusting related party transactions both internationally and by New Zealand. Within the ambit of the arm's length principle people could reasonably expect some aspects of the legislation to change and it might be hard to justify grandparenting. However, if New Zealand legislation were to move outside this principle and tax profits greater than an arm's length profit (the result that in some cases will seem inevitably to arise with the proposed interest cap) this is a surprise. Objectively considered, this is beyond the reasonable or rational and legitimate expectations of international investors.

Investments have been made on the commercial basis that New Zealand would accept loans with arm's length terms and conditions. That is a reasonable expectation for investors to make. To now impose new rules contrary to such expectations would adversely and retrospectively affect investment decisions.

Thus, if New Zealand were to proceed with the interest cap proposal without grandparenting provisions for existing investments, this would be contrary to long-standing policy adopted in New Zealand with respect to tax changes with retrospective effect. In accordance with that long standing policy, and in recognition of the economic and social benefits of certainty of the law, any such change in policy should have a grandparenting provision so that existing related party loans should not be subject to an interest rate cap although such loans might subject to the more orthodox arm's length test.

We would welcome the opportunity to meet with you to discuss this submission.

Yours faithfully
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18 April 2017

BEPS – Interest limitation rules
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Policy and Strategy
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Submission: "BEPS - strengthening our interest limitation rules" discussion document

We outline in this letter our submission on the Government discussion document "BEPS - strengthening our interest limitation rules", which was released on 3 March 2017 (the **discussion document**).

We welcome the opportunity to make this submission, and would be happy to discuss further with officials if that would assist in understanding and appropriately taking into account our key concerns as part of the consultation process.

Introduction – overview of First Gas

First Gas Limited (**First Gas**) owns and operates New Zealand's entire high-pressure natural gas transmission network, as well as more than 4,800 km of gas distribution pipelines across the North Island which, on behalf of gas retailers, deliver gas to more than 60,000 customers.

First Gas, formerly Vector Gas Limited, was acquired in 2016 by a consortium of foreign investors including two wholesale unlisted infrastructure funds managed by First State Investments (**FSI**) group entities, along with a co-investment from two Canadian institutional fund managers. FSI (known as Colonial First State Global Asset Management in Australia) is the investment management business of the Commonwealth Bank of Australia.

First Gas subsequently acquired the Maui gas pipeline from its long term owners, and has recently acquired further gas distribution pipelines in the Bay of Plenty.

Summary of submission

We summarise our key submission points as follows:

- The non-debt liabilities proposal will inequitably penalise infrastructure businesses - which are by nature highly geared and capital intensive - and will result in unjustifiably prejudicial treatment of foreign vs locally owned businesses in that and other highly geared sectors.

- Deferred tax liabilities, which can be disproportionately significant for owners of regulated infrastructure as compared with other taxpayers, are analogous to equity and should not be subtracted from asset values.

- If the non-debt liabilities proposal goes ahead, the availability of different asset valuation methods should be reconsidered, in the interests of most accurately identifying the value of assets that are funded by those liabilities and debt.

- Abolishing asset and liability measurement at the end of the income year imposes significant additional compliance costs: the status quo does not impose an unreasonable burden on

taxpayers in terms of assessing their thin capitalisation position, which in turn encourages compliance.

- The interest rate cap is without international precedent and may cause inequities at the boundary / increase the risk of double taxation: it should not proceed. It appears to be based on an unreasonable assumption that New Zealand entities are implicitly supported by their foreign parent/related parties.

- If the interest rate cap proposal proceeds, this should only be as a safe harbour backstop for existing transfer pricing rules. In addition, the rules concerning the allowable margin should not result in different treatment depending on different ownership structures, and the five year term should be reconsidered because it is not commercially realistic (particularly for infrastructure debt financing: a one-size-fits-all approach, although attractive for its simplicity, does not reflect commercial reality).

- The issue being addressed by the "strengthened" interest limitation rules is best solved through the application of orthodox transfer pricing principles.

- Significant investment decisions with a long-term horizon have been made by FSI and other infrastructure investors based on then current New Zealand tax law. The current tax treatment of existing financing arrangements entered into by FSI and other infrastructure investors should be preserved through appropriate grandparenting measures. This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. First Gas' significant capex needs mean they require ready access to debt and equity funding from the global capital markets. Given the importance of infrastructure to New Zealand's economic growth and productivity in the future, tax settings should be encouraging further foreign direct investment (via both debt and equity) into New Zealand infrastructure assets – not discouraging it.

General comments

First Gas recognises the significance of the OECD's BEPS project and Inland Revenue's work programme in that regard. Clearly it is important that all New Zealand tax resident businesses (including those that are owned or controlled by offshore investors) are subject to an appropriate level of taxation in New Zealand.

However, First Gas is concerned that the discussion document's proposals will result in horizontal inequity between businesses owned/controlled by offshore investors as compared with those in New Zealand ownership. In particular, long term infrastructure businesses with regulated asset bases (such as in the energy industry) are significantly supported by overseas capital and accordingly are likely to be disproportionately impacted by the proposals.

The proposals in their current form do not recognise that infrastructure businesses are invested into on a long-term basis, and by their nature are capital intensive and highly geared. With a relatively low regulatory WACC allowed by the regulator and the need to reinvest capital to maintain and expand the asset, it is inevitable that infrastructure businesses (in particular regulated utilities) will need to borrow significantly to achieve a commercial return demanded from its global financial sponsors: it does not reflect any lack of commerciality in terms of debt levels (but, rather, a sensible investment decision and a norm). If the proposals are enacted in their current form, there is a real and appreciable risk of an adverse impact upon offshore investment decision-making as regards whether to invest in New Zealand-based infrastructure, or elsewhere globally.

Given that New Zealand is heavily reliant on foreign direct investment as a capital importing nation, the proposals warrant serious reconsideration. This is particularly the case given New Zealand's very shallow capital market, and First Gas' (and other regulated infrastructure firms') capex-intensive business models that demand constant and unimpeded access to vitally important investment capital. Any tax policy settings that make New Zealand infrastructure assets an unattractive destination for that capital pose serious risks to the infrastructure sector's economic viability, for New Zealand's energy needs and correspondingly our country's economic growth and prosperity.

If the proposals are enacted in their current form, First Gas has serious concerns regarding the impact on the availability and cost of capital for itself and other New Zealand infrastructure businesses.

Assets net of non-debt liabilities

The discussion document proposes to subtract the value of non-debt liabilities from a firm's asset value for the purposes of the thin capitalisation rules (**thin cap**). This is based on an international comparison which indicates that a 'gross assets' basis for thin cap is unique to New Zealand.

We do not support this proposal, which materially reduces the long-standing 60% safe harbour threshold. Beyond stating that the proposal seems to make thin cap more consistent with its "core objectives", we are concerned that the discussion document does not set out a properly reasoned case for this change.

Further, the proposal does not recognise that the funding of business assets via non-debt liabilities is a legitimate investment decision. Non-debt liabilities generally (but not always: deferred tax liabilities being one example) reflect the existence of real obligations for taxpayers, which are required to be met by equally real business assets. It is difficult to see why these assets should be effectively excluded from a firm's thin cap calculation.

Conversely, certain non-debt liabilities that would be subtracted in arriving at net assets under the current proposals do not actually fund assets on the balance sheet (for example, an unrealised liability recorded in respect of an out-of-the-money derivative). In these cases we do not consider it is appropriate to arbitrarily exclude a corresponding amount of assets from the thin cap calculation. Such an approach could also encourage firms to make tax-driven decisions in relation to their accounting policies (again, hedging/derivatives is an obvious example), in order to ensure that corresponding assets are reflected in their balance sheet, thereby mitigating or eliminating the impact of a net assets measurement.

As a general observation, we consider that the existing 60% thin cap safe harbour is already too low for the infrastructure industry. Long term infrastructure businesses (particularly regulated utilities) are by their very nature likely to be geared above this level. As explained above, the use of debt is a sensible approach to balancing the need of consumers (e.g. low WACC / tariff setting, proper maintenance and expansion of assets) and the need for acceptable commercial returns of financial sponsors. The high level of gearing is acceptable to lenders due to the stable, long term nature of infrastructure businesses, and given that the ability to service debt is ultimately determined by cash coverage rather than balance sheet type ratios. Given these settings, the industry will therefore be disproportionately penalised as a result of these changes.

Rather than changing the basis for the current 60% safe harbour, we suggest instead an additional arm's length safe harbour test to allow taxpayers to gear at higher levels where this is supportable as being a commercial level of debt. This is a feature of thin cap regimes in a substantial number of jurisdictions. We consider that this would address Officials' concerns regarding industry specific rules noted at paragraph 4.29 of the discussion document. Further, this proposal would be more consistent with Officials' stated goal of ensuring taxpayers (including different types of taxpayers) have commercial levels of debt. It is also consistent with other features of the New Zealand taxation system that require taxpayers to demonstrate qualitative matters such as a "market value" (depreciable property/trading stock rules on disposal and dividend rules), an "arm's length amount" (transfer pricing) or "arm's length terms" (on-lending concession for thin cap purposes).

However, if the non-debt liabilities proposal does proceed, we strongly submit that a more considered approach should be taken to identifying which such liabilities are subtracted from the value of assets. For example, as is the case in Australia, deferred tax liabilities should not be carved out from the total asset value as they are normally not regarded as a 'real liability' by a debt funder and can be classified as equity for debt covenant purposes. Contingent liabilities to pay amounts upon redemption of redeemable shares, related party trade creditors and shareholder current accounts (if not already covered by interest-free loans) are additional examples.

Further, if the proposal is implemented, we submit that other aspects of the thin cap rules should be reconsidered to ensure that taxpayers are able to value their asset base in a commercially realistic manner. In particular, Officials recommend at paragraphs 5.24 to 5.27 of the discussion document that asset valuation should now be restricted to financial statements values only. By contrast,

Australia offers a more generous market valuation option for assets in certain circumstances, subject to obtaining appropriate third party valuation support. This should be considered by Officials as a way of ensuring that thin cap measures interest bearing debt against the true value of shareholders' investment.

Measurement date for assets and liabilities

We do not support the proposal to remove the current default (annual) asset valuation measurement date. This will in effect require taxpayers to prepare IFRS-based values on at least a quarterly basis, in most cases solely for tax purposes. Because IFRS requires a number of complex calculations (e.g. impairment testing, fair value and mark to market calculations), it would otherwise be very unusual to prepare these values so frequently. This proposal will therefore impose significant additional compliance costs for taxpayers. By contrast, the status quo represents a sensible approach for taxpayers to assess their thin cap position (i.e. simply based on their annual accounts – with the current value approach as an option as submitted above), which in turn encourages compliance.

The discussion document indicates that Inland Revenue's concern with the year end measurement date arises from perceived shortcomings in the existing anti-avoidance rule in section FE 11 of the Income Tax Act 2007. As these concerns are presumably relevant in only a small number of isolated cases (the discussion document does not cite anecdotal evidence supporting what is otherwise a theoretical concern), it is vastly disproportionate to impose significant additional compliance costs on all taxpayers. We submit that targeted amendments to the anti-avoidance rule would be a more appropriate policy response.

Interest rate cap – assumptions

As a starting point, we consider that the proposed interest rate cap appears to assume the implicit support of New Zealand entities by their foreign related parties. This assumption ignores the separate legal entity principle, as well as business and economic reality. Except where an enforceable guarantee is provided by a foreign owner, it is fundamentally flawed to assume that a multinational parent (and especially a consortium investor such as is the case in relation to First Gas) will always support a New Zealand related party.

Interest rate cap – use of transfer pricing principles

As a result of concerns that 'traditional' thin cap regimes are vulnerable to excessive interest rates on related party loans, the discussion document proposes a cap on the deductibility of such interest. However, as in Australia and numerous other jurisdictions with thin cap regimes, we consider that orthodox transfer pricing rules are adequate to ensure that related-party lending is conducted on arm's length terms.

As a result, we do not support the proposed interest rate cap. We are concerned that the cap is a blunt instrument which will increase horizontal inequity between locally and foreign owned businesses. The proposal is untested and to our knowledge is without international precedent (and in this regard we have identified fundamental/conceptual concerns above, and further specific concerns below). We are also concerned that, particularly when combined with the other proposals, the interest rate cap will introduce a unique level of complexity to New Zealand thin cap relative to other jurisdictions.

The cap also introduces a substantial double taxation risk where the lender's jurisdiction applies transfer pricing principles. Although the same could be true for thin cap interest apportionment to a certain extent, it is relatively straightforward for a taxpayer to manage debt levels within thin cap thresholds. The mutual agreement process has also historically allowed competent authorities to resolve more complex double taxation issues. However, we are concerned that the impact of the interest rate cap, together with the proposed treatment of non-debt liabilities, introduces a more substantial risk of double taxation.

As a way of addressing these deficiencies, we submit that the concerns sought to be addressed by the proposed interest rate cap should be dealt with instead through orthodox transfer pricing rules. We consider that this more closely aligns with, and less invasively gives effect to, the stated policy objective of preventing profit shifting by way of excessive interest deductions.

We note the discussion document's warning that if an interest limitation rule will not achieve its stated objectives, then an EBITDA based rule (as suggested by the OECD) may need to be adopted. We do not agree that an EBITDA based rule is a necessary result of rejecting the interest rate cap. As recognised in the discussion document, such a rule has its own challenges and, as noted above, the policy concern can be adequately addressed via existing transfer pricing rules.

Further, given the recent bolstering of the NRWT rules with respect to related party debt, we consider that New Zealand should be less concerned with base erosion and profit shifting resulting from interest on related party debt. New Zealand's comprehensive application of NRWT to passive income streams (including now where consortia will not be able to access the approved issuer levy regime) can be contrasted with the difficulties of European Union members and some other nations, who are unable to use withholding tax with similar efficacy[1]. Further, in certain related party situations (i.e. involving associated persons) where NRWT is only a minimum tax, investors may nevertheless be subject to a full New Zealand income tax burden on the relevant income stream. As a result, we consider that some of the concerns leading to the recommendation of an EBITDA based measure (or indeed, an interest cap rule) are not relevant in a New Zealand environment.

Finally, if the interest rate cap proposal does proceed, First Gas considers that it should have application only as a 'safe harbour' backstop for the existing transfer pricing rules. Taxpayers who are willing and able to undertake a full transfer pricing analysis to support arm's length pricing for related party debt should not have interest rate deductions limited by an arbitrary cap. The cap should therefore be limited to circumstances where a taxpayer does not undertake full transfer pricing analysis. We consider this would mitigate some of the concerns with the cap detailed above.

Interest rate cap – design matters

If the interest rate cap proposal does proceed, we submit that the proposed five year maximum term (when looking to senior unsecured debt issuance pricing as a base from which to notch) is too short, particularly in industries with stable cash flows and a solid long term asset base. Too short a term is uncommercial and risks giving rise to non-arm's length outcomes.

Particularly from an infrastructure perspective, a five year term is demonstrably too short. In a New Zealand specific context (e.g. PPPs), Officials will be aware of senior debt with terms of seven years or longer. In Australasian markets, ten year infrastructure bonds are not unusual and longer terms up to thirteen years are available in overseas capital markets. Similarly, First Gas understands from FSI (and in First Gas' own experience) that related party loans will normally have a term between five to ten years. Hence a five year term represents an overly restrictive assumption.

Given New Zealand's status as a net capital importer, we consider it would be unwise to restrict taxpayers' interest rate cap calculations from being based on appropriately priced overseas debt financing in the manner proposed by Officials (or, indeed, to restrict access to such financing itself).

As a result, we consider that the appropriate term needs to vary across industries and across credit cycles. As has been the practice with transfer pricing matters, Inland Revenue could provide more tailored guidance on what it considers uncommercial in the context of intercompany debt.

Alternatively, if a hard cap is imposed, this should err on the side of being higher than the proposed five year term to avoid arbitrarily and unduly penalising investors.

The proposed approach for adding a margin also raises horizontal equity issues. In particular, the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating is inequitable. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. This is preferable as a matter of tax policy to minimise the extent to which investment decisions are impacted by tax rules.

Grandparenting for existing arrangements

[1] For further comments in this regard, see for example: OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

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The current long-standing tax policy settings have critically informed a number of significant investment decisions, including the FSI-managed consortium's own recent investment in New Zealand.

For any infrastructure investor, the pre and post-tax yields of an investment are significant outputs from the valuation and modelling process that is undertaken prior to making, and in ascertaining the viability of making, that investment. Based on those settings, resulting yields and other factors, FSI made a significant commercial decision to financially sponsor a material investment into New Zealand's energy infrastructure and recommend the investment accordingly to the current consortium members (comprising wholesale infrastructure funds and various institutional/sovereign or quasi-sovereign agency investors).

Uncertainty and risk is of course inherent in any investment, particularly over the extended modelling horizon that is used by long term infrastructure investors. The consortium that has invested into First Gas has already been affected by the changes to availability of the approved issuer levy regime. The impact of the proposals in the discussion document, if enacted in their current form, would further materially affect the post-tax return on the significant investment that the consortium has made in a core feature of New Zealand's infrastructure landscape. As a result, we submit that the proposals, if enacted, should include grandparenting, particularly for arrangements entered into before the release of the discussion document and in particular in the infrastructure sector where long-term investment decisions are made.

This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. As noted above, First Gas' significant capex needs mean require ready access to debt and equity funding from the global capital markets. Given the importance of infrastructure to New Zealand's economic growth and productivity in the future, tax settings should be encouraging further foreign direct investment (via both debt and equity) into New Zealand infrastructure assets – not discouraging it.

The rationale and case for grandparenting for non-PPP infrastructure investment is just as compelling as for the PPP projects referenced at paragraph 5.12ff of the discussion document (except we would submit that owner-linked debt should not be non-deductible as proposed by the discussion document and instead a section FE 31D-style regime should apply as is referenced in paragraph 5.14 of the discussion document: transfer pricing measures can constrain any quality of debt issues). If similar grandparenting is not introduced, then a horizontal inequity will arise as between Government-sponsored and private sector-sponsored key infrastructure investment in New Zealand. To this end First Gas also supports the grandparenting of the operation of section FE 31D in relation to non-resident owning body debt entered into prior to enactment of the proposed reforms. First Gas also submits that for non-grandparented consortia arrangements it is a disproportionate policy response to deny all interest deductions on shareholder debt.

Concluding comments

Thank you again for the opportunity to submit on the discussion document. Should you have any further queries or wish to discuss this submission further, please contact me on (06) 755 0861 or by email at david.smith@firstgas.co.nz.

Yours faithfully

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18 April 2017

BEPS – Interest limitation rules
c/- Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

By email: policy.webmaster@ird.govt.nz

Submission: "BEPS - strengthening our interest limitation rules" discussion document

We outline in this letter our submission on the Government discussion document "BEPS - strengthening our interest limitation rules", which was released on 3 March 2017 (the **discussion document**).

We welcome the opportunity to make this submission, and would be happy to discuss further with officials if that would assist in understanding and appropriately taking into account our key concerns as part of the consultation process.

Introduction – overview of FSI

First State Investments (FSI) (operating as Colonial First State Global Asset Management in Australia) is the investment management business of the Commonwealth Bank of Australia. We are a global asset manager with established offices across Europe, the US, Middle East, and Asia Pacific regions. FSI has stewardship of over US$147.2 billion in assets managed on behalf of institutional investors, pension funds, wholesale distributors, investment platforms, financial advisers and their clients worldwide.

FSI is one of the pioneer infrastructure investors in Australia, with a 20-plus year track record of investing in infrastructure assets on behalf of over 85 institutional investors. We also have experience in managing 51 infrastructure investments in Europe, Australia and Asia since September 1994 with an infrastructure portfolio valued at approximately US$5.8 billion as at 31 December 2016. We adopt a long-term buy and hold investment approach focused on value creation through continuous investment.

Two wholesale unlisted infrastructure funds managed by FSI, along with a co-investment from two Canadian institutional fund managers, recently made their first (and a significant) investment in New Zealand as part of the consortium which in 2016 acquired both First Gas Limited (formerly Vector Gas Limited) and the Maui gas pipeline (collectively "First Gas"). The First Gas business now operates New Zealand's entire high-pressure natural gas transmission network, as well as more than 4,800 km of gas distribution pipelines across the North Island which, on behalf of gas retailers, deliver gas to more than 60,000 customers.

Summary of submission

We summarise our key submission points as follows:

- The non-debt liabilities proposal will inequitably penalise infrastructure businesses - which are by nature highly geared and capital intensive - and will result in unjustifiably prejudicial treatment of foreign vs locally owned businesses in that and other highly geared sectors.

- Deferred tax liabilities, which can be disproportionately significant for owners of regulated infrastructure as compared with other taxpayers, are analogous to equity and should not be subtracted from asset values.

- If the non-debt liabilities proposal goes ahead, the availability of different asset valuation methods should be reconsidered, in the interests of most accurately identifying the value of assets that are funded by those liabilities and debt.

- Abolishing asset and liability measurement at the end of the income year imposes significant additional compliance costs: the status quo does not impose an unreasonable burden on taxpayers in terms of assessing their thin capitalisation position, which in turn encourages compliance.

- The interest rate cap is without international precedent and may cause inequities at the boundary / increase the risk of double taxation: it should not proceed. It appears to be based on an unreasonable assumption that New Zealand entities are implicitly supported by their foreign parent/related parties.

- If the interest rate cap proposal proceeds, this should only be as a safe harbour backstop for existing transfer pricing rules. In addition, the rules concerning the allowable margin should not result in different treatment depending on different ownership structures, and the five year term should be reconsidered because it is not commercially realistic (particularly for infrastructure debt financing: a one-size-fits-all approach, although attractive for its simplicity, does not reflect commercial reality).

- The issue being addressed by the "strengthened" interest limitation rules is best solved through the application of orthodox transfer pricing principles.

- Significant investment decisions with a long-term horizon have been made by FSI and other infrastructure investors based on then current New Zealand tax law. The current tax treatment of existing financing arrangements entered into by FSI and other

infrastructure investors should be preserved through appropriate grandparenting measures. This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future.

General comments

FSI recognises the significance of the OECD's BEPS project and Inland Revenue's work programme in that regard. Clearly it is important that all New Zealand tax resident businesses (including those that are owned or controlled by offshore investors) are subject to an appropriate level of taxation in New Zealand.

However, FSI is concerned that the discussion document's proposals will result in horizontal inequity between businesses owned/controlled by offshore investors as compared with those in New Zealand ownership. In particular, long term infrastructure businesses with regulated asset bases (such as in the energy industry) are significantly supported by overseas capital and accordingly are likely to be disproportionately impacted by the proposals.

The proposals in their current form do not recognise that infrastructure businesses are invested into on a long-term basis, and by their nature are capital intensive and highly geared. With a relatively low regulatory WACC allowed by the regulator and the need to reinvest capital to maintain and expand the asset, it is inevitable that infrastructure businesses (in particular regulated utilities) will need to borrow significantly to achieve a commercial return demanded from its global financial sponsors: it does not reflect any lack of commerciality in terms of debt levels (but, rather, a sensible investment decision and a norm). If the proposals are enacted in their current form, there is a real and appreciable risk of an adverse impact upon offshore investment decision-making as regards whether to invest in New Zealand-based infrastructure, or elsewhere globally. Given New Zealand's need for foreign direct investment as a capital importing nation, the proposals warrant serious reconsideration.

Assets net of non-debt liabilities

The discussion document proposes to subtract the value of non-debt liabilities from a firm's asset value for the purposes of the thin capitalisation rules (**thin cap**). This is based on an international comparison which indicates that a 'gross assets' basis for thin cap is unique to New Zealand.

We do not support this proposal, which materially reduces the long-standing 60% safe harbour threshold. Beyond stating that the proposal seems to make thin cap more consistent with its "core objectives", we are concerned that the discussion document does not set out a properly reasoned case for this change.

Further, the proposal does not recognise that the funding of business assets via non-debt liabilities is a legitimate investment decision. Non-debt liabilities generally (but not always: deferred tax liabilities being one example) reflect the existence of real obligations for taxpayers, which are required to be met by equally real business assets. It is difficult to see why these assets should be effectively excluded from a firm's thin cap calculation.

Conversely, certain non-debt liabilities that would be subtracted in arriving at net assets under the current proposals do not actually fund assets on the balance sheet (for example, an unrealised liability recorded in respect of an out-of-the-money derivative). In these cases we do not consider it is appropriate to arbitrarily exclude a corresponding amount of assets from the thin cap calculation. Such an approach could also encourage firms to make tax-driven decisions in relation to their accounting policies (again, hedging/derivatives is an obvious example), in order to ensure that corresponding assets are reflected in their balance sheet, thereby mitigating or eliminating the impact of a net assets measurement.

As a general observation, we consider that the existing 60% thin cap safe harbour is already too low for the infrastructure industry. In FSI's experience, long term infrastructure businesses (particularly regulated utilities) are by their very nature likely to be geared above this level. As explained above, the use of debt is a sensible approach to balancing the need of consumers (e.g. low WACC / tariff setting, proper maintenance and expansion of assets) and the need for acceptable commercial returns for financial sponsors. The high level of gearing is acceptable to lenders due to the stable, long term nature of infrastructure businesses, and that the ability to servicing debt is ultimately determined by cash coverage rather than balance sheet type ratios. Given the above setting, the industry will therefore be disproportionately penalised as a result of these changes.

Rather than changing the basis for the current 60% safe harbour, we suggest instead an additional arm's length safe harbour test to allow taxpayers to gear at higher levels where this is supportable as being a commercial level of debt. This is a feature of thin cap regimes in a substantial number of jurisdictions. We consider that this would address Officials' concerns regarding industry specific rules noted at paragraph 4.29 of the discussion document. Further, this proposal would be more consistent with Officials' stated goal of ensuring taxpayers (including different types of taxpayers) have commercial levels of debt. It is also consistent with other features of the New Zealand taxation system that require taxpayers to demonstrate qualitative matters such as a "market value" (depreciable property/trading stock rules on disposal and dividend rules), an "arm's length amount" (transfer pricing) or "arm's length terms" (on-lending concession for thin cap purposes).

However, if the non-debt liabilities proposal does proceed, we strongly submit that a more considered approach should be taken to identifying which such liabilities are subtracted from the value of assets. For example, as is the case in Australia, deferred tax liabilities should not be carved out from the total asset value as they are normally not regarded as a 'real liability' by a debt funder and can be classified as equity for debt covenant purposes. Contingent liabilities to pay amounts upon redemption of redeemable shares, related party trade creditors and shareholder current accounts (if not already covered by interest-free loans) are additional examples.

Further, if the proposal is implemented, we submit that other aspects of the thin cap rules should be reconsidered to ensure that taxpayers are able to value their asset base in a commercially realistic manner. In particular, Officials recommend at paragraphs 5.24 to 5.27 of the discussion document that asset valuation should now be restricted to financial statements values only. By contrast, Australia offers a more generous market valuation option for assets in certain circumstances, subject to obtaining appropriate third party valuation support. This should be considered by Officials as a way of ensuring that thin cap measures interest bearing debt against the true value of shareholders' investment.

Measurement date for assets and liabilities

We do not support the proposal to remove the current default (annual) asset valuation measurement date. This will in effect require taxpayers to prepare IFRS-based values on at least a quarterly basis, in most cases solely for tax purposes. Because IFRS requires a number of complex calculations (e.g. impairment testing, fair value and mark to market calculations), it would otherwise be very unusual to prepare these values so frequently. This proposal will therefore impose significant additional compliance costs for taxpayers. By contrast, the status quo represents a sensible approach for taxpayers to assess their thin cap position (i.e. simply based on their annual accounts – with the current value approach as an option as submitted above), which in turn encourages compliance.

The discussion document indicates that Inland Revenue's concern with the year end measurement date arises from perceived shortcomings in the existing anti-avoidance rule in section FE 11 of the Income Tax Act 2007. As these concerns are presumably relevant in only a small number of isolated cases (the discussion document does not cite anecdotal evidence supporting what is otherwise a theoretical concern), it is vastly disproportionate to impose significant additional compliance costs on all taxpayers. We submit that targeted amendments to the anti-avoidance rule would be a more appropriate policy response.

Interest rate cap – assumptions

As a starting point, we consider that the proposed interest rate cap appears to assume the implicit support of New Zealand entities by their foreign related parties. This assumption ignores the separate legal entity principle, as well as business and economic reality. Except where an enforceable guarantee is provided by a foreign owner, it is fundamentally flawed to assume that a multinational parent (and especially a consortium investor such as is the case in relation to First Gas) will always support a New Zealand related party.

Interest rate cap – use of transfer pricing principles

As a result of concerns that 'traditional' thin cap regimes are vulnerable to excessive interest rates on related party loans, the discussion document proposes a cap on the deductibility of such interest. However, as in Australia and numerous other jurisdictions with thin cap regimes, we consider that orthodox transfer pricing rules are adequate to ensure that related-party lending is conducted on arm's length terms.

As a result, we do not support the proposed interest rate cap. We are concerned that the cap is a blunt instrument which will increase horizontal inequity between locally and foreign owned businesses. The proposal is untested and to our knowledge is without international precedent (and in this regard we have identified fundamental/conceptual concerns above, and further specific concerns below). We are also concerned that, particularly when combined with the other proposals, the interest rate cap will introduce a unique level of complexity to New Zealand thin cap relative to other jurisdictions.

The cap also introduces a substantial double taxation risk where the lender's jurisdiction applies transfer pricing principles. Although the same could be true for thin cap interest apportionment to a certain extent, it is relatively straightforward for a taxpayer to manage debt

levels within thin cap thresholds. The mutual agreement process has also historically allowed competent authorities to resolve more complex double taxation issues. However, we are concerned that the impact of the interest rate cap, together with the proposed treatment of non-debt liabilities, introduces a more substantial risk of double taxation.

As a way of addressing these deficiencies, we submit that the concerns sought to be addressed by the proposed interest rate cap should be dealt with instead through orthodox transfer pricing rules. We consider that this more closely aligns with, and less invasively gives effect to, the stated policy objective of preventing profit shifting by way of excessive interest deductions.

We note the discussion document's warning that if an interest limitation rule will not achieve its stated objectives, then an EBITDA based rule (as suggested by the OECD) may need to be adopted. We do not agree that an EBITDA based rule is a necessary result of rejecting the interest rate cap. As recognised in the discussion document, such a rule has its own challenges and, as noted above, the policy concern can be adequately addressed via existing transfer pricing rules.

Further, given the recent bolstering of the NRWT rules with respect to related party debt, we consider that New Zealand should be less concerned with base erosion and profit shifting resulting from interest on related party debt. New Zealand's comprehensive application of NRWT to passive income streams (including now where consortia will not be able to access the approved issuer levy regime) can be contrasted with the difficulties of European Union members and some other nations, who are unable to use withholding tax with similar efficacy[1]. Further, in certain related party situations (i.e. involving associated persons) where NRWT is only a minimum tax, investors may nevertheless be subject to a full New Zealand income tax burden on the relevant income stream. As a result, we consider that some of the concerns leading to the recommendation of an EBITDA based measure (or indeed, an interest cap rule) are not relevant in a New Zealand environment.

Finally, if the interest rate cap proposal does proceed, FSI considers that it should have application only as a 'safe harbour' backstop for the existing transfer pricing rules. Taxpayers who are willing and able to undertake a full transfer pricing analysis to support arm's length pricing for related party debt should not have interest rate deductions limited by an arbitrary cap. The cap should therefore be limited to circumstances where a taxpayer does not undertake full transfer pricing analysis. We consider this would mitigate some of the concerns with the cap detailed above.

Interest rate cap – design matters

If the interest rate cap proposal does proceed, we submit that the proposed five year maximum term (when looking to senior unsecured debt issuance pricing as a base from which to notch) is too short, particularly in industries with stable cash flows and a solid long term asset base. Too short a term is uncommercial and risks giving rise to non-arm's length outcomes.

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[1] For further comments in this regard, see for example: OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

Particularly from an infrastructure perspective, a five year term is demonstrably too short. In a New Zealand specific context (e.g. PPPs), Officials will be aware of senior debt with terms of seven years or longer. In Australasian markets, ten year infrastructure bonds are not unusual and longer terms up to thirteen years are available in overseas capital markets. Similarly, from FSI's experience, related party loans will normally have a term between five to ten years. Hence a five year term represents an overly restrictive assumption.

Given New Zealand's status as a net capital importer, we consider it would be unwise to restrict taxpayers' interest rate cap calculations from being based on appropriately priced overseas debt financing in the manner proposed by Officials (or, indeed, to restrict access to such financing itself).

As a result, we consider that the appropriate term needs to vary across industries and across credit cycles. As has been the practice with transfer pricing matters, Inland Revenue could provide more tailored guidance on what it considers uncommercial in the context of intercompany debt.

Alternatively, if a hard cap is imposed, this should err on the side of being higher than the proposed five year term to avoid arbitrarily and unduly penalising investors.

The proposed approach for adding a margin also raises horizontal equity issues. In particular, the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating is inequitable. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. This is preferable as a matter of tax policy to minimise the extent to which investment decisions are impacted by tax rules.

Grandparenting for existing arrangements

The current long-standing tax policy settings have critically informed a number of significant investment decisions, including the FSI-managed consortium's own recent investment in New Zealand.

For any infrastructure investor, the pre and post-tax yields of an investment are significant outputs from the valuation and modelling process that is undertaken prior to making, and in ascertaining the viability of making, that investment. Based on those settings, resulting yields and other factors, FSI made a significant commercial decision to financially sponsor a material investment into New Zealand's energy infrastructure and recommend the investment accordingly to the current consortium members (comprising wholesale infrastructure funds and various institutional/sovereign or quasi-sovereign agency investors).

Uncertainty and risk is of course inherent in any investment, particularly over the extended modelling horizon that is used by long term infrastructure investors. The consortium that has invested into First Gas has already been affected by the changes to availability of the approved issuer levy regime. The impact of the proposals in the discussion document, if enacted in their current form, would further materially affect the post-tax return on the significant investment that the consortium has made in a core feature of New Zealand's infrastructure landscape. As a result, we submit that the proposals, if enacted, should include grandparenting, particularly for arrangements entered into before the release of the discussion

document and in particular in the infrastructure sector where long-term investment decisions are made.

This is a critical step in maintaining the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand's infrastructure needs into the future. The rationale and case for grandparenting for non-PPP infrastructure investment is just as compelling as for the PPP projects referenced at paragraph 5.12ff of the discussion document (except we would submit that owner-linked debt should not be non-deductible as proposed by the discussion document and instead a section FE 31D-style regime should apply as is referenced in paragraph 5.14 of the discussion document: transfer pricing measures can constrain any quality of debt issues). If similar grandparenting is not introduced, then a horizontal inequity will arise as between Government-sponsored and private sector-sponsored key infrastructure investment in New Zealand. To this end FSI also supports the grandparenting of the operation of section FE 31D in relation to non-resident owning body debt entered into prior to enactment of the proposed reforms. FSI also submits that for non-grandparented consortia arrangements it is a disproportionate policy response to deny all interest on shareholder debt.

Concluding comments

Thank you again for the opportunity to submit on the discussion document. Should you have any further queries or wish to discuss this submission further, please contact Jimmy Noh (Executive Advisor, Taxation – Colonial First State Global Asset Management) on 9(2)(a) [redacted] or by email at jnoh@colonialfirststate.com.au.

Yours faithfully,

Gavin Kerr
Director, Infrastructure Investments
First State Investments

NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

Submission of the New Zealand Council of Trade Unions Te Kauae Kaimahi

to the

Inland Revenue Department

on the

Proposals to strengthen New Zealand's rules for taxing large multinationals (BEPS)

P O Box 6645
Wellington
18 April 2017

1.1. This submission is made on behalf of the 30 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With 320,000 members, the CTU is one of the largest democratic organisations in New Zealand.

1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.

1.3. Thank you for the opportunity to comment on the three discussion papers on "Base erosion and profit shifting" (BEPS):[1]

- BEPS – Transfer pricing and permanent establishment avoidance
- BEPS – Strengthening our interest limitation rules
- New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.

1.4. We have read these and support their general directions. We make this brief submission in order to indicate our ongoing interest in these matters and our wish to be consulted as this area of policy progresses.

1.5. The loss of revenue from tax avoidance and evasion has a direct impact on our members in loss of revenue for public services which we value, and in higher taxes than otherwise necessary on working people.

1.6. One area is of special concern: the avoidance of tax by multinational internet-based corporations such as Google and Facebook puts local carriers of advertising such as newspapers and broadcast television and radio at a competitive disadvantage. The business model of conventional news media is already severely weakened by changes in technology brought largely through the internet and other forms of digital media and communications. The advertising revenue on which the conventional media depend is undermined by these new technologies, which they are struggling to respond to. It makes it even more difficult if their competition can lower their costs by avoiding paying tax on their activities.

[1] http://taxpolicy.ird.govt.nz/consultation

1.7. This is a matter of public interest: the conventional media are still the principal originators of the content on which we largely depend for reliable news, and particularly for news about New Zealand. The steady loss of capacity through lay-offs of journalists and other media staff is creating a major failure in the news media market.

1.8. There is therefore a strong public interest case to ensure that provision of advertising services and platforms is tax neutral. We are gravely disappointed that the proposals do not address the tax avoidance of Google, Facebook and others. We urge IRD to address this.

1.9. The only other matter we would like to comment on is that it would be very valuable for IRD to regularly publish summary information on the taxation of multinationals in the New Zealand. This would give the public the information that is necessary and sufficient for informed discussion of such matters and to judge whether measures such as those discussed in the present documents are effective. We urge IRD to do so.

TP EQuilibrium | AustralAsia LP

A Duff & Phelps Transfer Pricing Alliance Partner

To: Deputy Commissioner of Taxation, Policy and Strategy, New Zealand Inland Revenue

From: Leslie Prescott-Haar, Stefan Sunde / TP EQuilibrium | AustralAsia LP

Subject: BEPS – Interest Limitation Rules

Date: 18 April 2017

TP EQuilibrium | AustralAsia ("TPEQ") has prepared this submission in respect of the New Zealand Government's discussion document, *BEPS – Strengthening our interest limitation rules*, published in March 2017.

TPEQ has prepared these comments on the discussion document specifically from a transfer pricing perspective. In this regard, we have limited our comments to certain proposals contained in Chapter 3 of the discussion document. As such, TPEQ has not commented on all aspects of the various proposals.

We are comfortable discussing these points raised further with Inland Revenue or Treasury officials, as may be requested.

The submission is generally structured in alignment with the structure of the discussion document, unless otherwise indicated.

Overall Comments

Our primary concern is the need to maintain the arm's length standard as a 'base case' for transfer pricing analyses. Any departures from the arm's length approach should be well supported on the grounds of protecting New Zealand's tax base, rather than based on the Inland Revenue's issues encountered in audits. As discussed below, some of the proposed changes require further consideration and explanation as to their necessity and justification as part of the wider Base Erosion and Profit Shifting ("BEPS") project.

In principle, TPEQ supports the proposed symmetry of inbound and outbound approaches, expressed in Para. 1.8. However, given the predominantly inbound nature of financial transactions in New Zealand that would be impacted by the proposed interest rate limitation rules, we acknowledge the inbound context of this discussion, but consider that the symmetrical approach is commercially disadvantageous to New Zealand-based multinationals.

Moreover, the proposed departure from the OECD's thin capitalisation approach under BEPS Action 4 by legislating an interest rate limit will adversely impact the compliance burden for multinationals with New Zealand operations, and arguably is inconsistent with the arm's length principle embedded in New Zealand's DTAs. Our technical view is that the Inland Revenue's position with respect to the arm's length nature of the proposed interest rate cap is inconsistent with seminal international case law (*The Queen v. General Electric Capital Canada Inc., 2010 FCA 344; Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092*). Referencing paras. 3.38 and 3.60, the IRD should clearly articulate why its preferences should outweigh and override the OECD BEPS guidance.

Further justification is needed to support the proposed non-arm's length approach

We are of the overarching view that the interest rate limitation outlined in paras. 3.17 et. seq. reflects a broad rejection of the arm's length principle for financial transactions. While we acknowledge the theoretical compliance and enforcement benefits of this approach to the Inland Revenue, we consider this 'rule making' an attempt to pre-determine or disregard an arm's length outcome. Para. 3.19 suggests an implicit acknowledgement by the Inland Revenue that the proposal does not necessarily reflect the behaviour of independent parties, given the provision would not apply to uncontrolled finance transactions as well. This is arguably discriminatory with regard to inter-company funding within multinationals, and therefore inappropriate from a policy perspective, particularly given the Government's stated commitment to FDI (para. 2.1). In this regard, intercompany funding is commercially cost-effective for multinationals, which is the primary reason these financial transactions arise. Although presented as the opening premise of the proposal (para. 1.1), the use of intercompany debt is not determinative of shifting of taxable profits. Multinationals should not be penalised for seeking to minimise financial costs, and the financial institutions operating in New Zealand should not be commercially advantaged through taxation legislation.

Capping the interest rate may not provide adequate flexibility to accommodate actual facts and circumstances

Further to the above, we are concerned that the interest rate cap is likely to be inflexible in its application. Consider an example where offshore borrowing costs are 5%, New Zealand borrowing costs are 7%, and offshore investment returns are 8%:

- From the borrower's perspective, the intra-group funding cost to the New Zealand borrower should arguably be at least 7%, as this is reflects the conditions that independent New Zealand or offshore parties borrowing in New Zealand would likely face.
- From the lender's perspective, by limiting the inbound interest rate to the New Zealand entity of 5% "plus some margin", the proposal reduces the attractiveness for multinationals to invest their global resources in New Zealand subsidiaries, relative to the offshore investment options. The New Zealand government should not create a framework which could discourage inbound foreign direct investment by multinationals.

Further, we note the real-world possibility that a New Zealand subsidiary may be able to borrow at an interest rate lower than its parent entity. Under the interest rate limitation proposal, the higher cost of funds available to the parent entity would presumably allow the New Zealand entity to enjoy interest rate deductions on a loan from its parent in excess of what is arguably an arm's length amount for the New Zealand borrower. A true arm's length comparison would be simpler.

Determining the "some margin" remains subjective, and 'pegging' the interest rate to a parent's cost of funds appears arbitrary and does not offer significant advantages over a true arm's length approach

Per para. 3.27 et. seq., the "some margin" proposed may reflect a practical approach to accommodate actual facts and circumstances of a particular case. However, determining the appropriate margin will likely be subjective. Imposing, as a starting (and approximate finishing) point, the interest rate at which the ultimate parent could borrow is arbitrary and does not appear to offer any significant advantages with regards to simplicity or objectivity, as compared to a true arm's length approach. Therefore, we suggest the introduction of this rule as a safe harbour only, rather than as a blunt legislative instrument which prevents an arm's length analysis.

Clearly, the additional margin to be adopted should take into account currency differences, market conditions, specific country/company issues, administrative costs of funding, etc. For example, should a New Zealand parent be forced by the Inland Revenue to lend to its USA subsidiary at New Zealand interest rates? Not all countries are equal in global financial markets. Thus, again, a true arm's length approach would be simpler.

Other specific details of the proposals are too rigid

Per para 3.41, there may be circumstances wherein third parties may agree to re-assess the interest rate and/or margin on a given loan, for example to account for changing conditions, mergers, acquisitions, etc. The IRD should account for such flexibility and consider a less rigid approach to the fixed margin / rate rule proposed.

Per para 3.53, the maximum term or tenor should be lifted to 10 years for determining the appropriate interest rate and additional margin. A 10 year tenor is not 'uncommercial' for long term inbound investments and in bond markets.

#008

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Australia

18 April 2017

Commercial in Confidence
Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON 6140

Dear Deputy Commissioner

Submission on the government discussion document - "BEPS - strengthening our interest limitation rules"

QIC Private Capital Pty Limited is a leading investor in the global infrastructure market and manages a 58% interest in Powerco NZ Holdings Limited (PNZHL) on behalf of Australian superannuation funds, Queensland Government entities and other large sophisticated investors. PNZHL is the holding company for Powerco Limited, which is New Zealand's second largest Electricity and Gas Distribution Company. Powerco Ltd owns infrastructure assets that transport electricity and gas to end customers in the residential, agricultural and industrial sectors.

We are writing in relation to the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). We appreciate the opportunity to make a submission on this discussion document.

The key items we raise in our submission are summarised as follows:

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact industries such as regulated infrastructure industries which have traditionally been funded using greater than average gearing given the predictable cash flows generated by their underlying businesses;
- This is exacerbated by the inclusion of deferred tax liabilities in the calculation of the deductible debt limit which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity;
- The interest rate cap is a novel and untested approach which we believe is unnecessary in light of the current and proposed transfer pricing rules and is inconsistent with internationally accepted transfer pricing requirements;
- In our view, the issue being addressed by the proposed interest rate cap is best solved through the application of the current and proposed transfer pricing rules;
- The proposed changes create an unequal playing field between foreign and New Zealand investors, which can have the impact of reducing appetite from foreign investors as well as potentially harming local New Zealand investors who frequently invest alongside foreign investors.
- As a net importer of capital, the proposed changes would increase the average cost of capital in New Zealand, particularly for capital-intensive industries where capital structures would likely

become less efficient, increasing the cost to New Zealand of building the infrastructure necessary to support and grow its economy.

Background

QIC appreciates that New Zealand needs to ensure that all businesses contribute an appropriate level of tax. However, in this context, we note the OECD as part of its BEPS project acknowledges that special rules may be needed for infrastructure businesses given their long-term capital intensive nature and public benefit outcome. The proposals suggested in the discussion document however are likely to result in horizontal inequity between businesses based on the residency of their owners and it will have the greatest impact on long term infrastructure businesses, which typically rely on at least a portion of overseas capital. Further, a series of recent law changes have already significantly reduced the perceived tax benefits that these measures are seeking to curtail.

Treatment of non-debt liabilities - Introduction of an arm's length fall back

The discussion document proposes changes in the current thin capitalisation rules to be based on assets net of non-debt liabilities rather than total assets. We consider the existing 60% gearing ratio to be too low for regulated public benefit infrastructure as external debt can be secured on economic terms in excess of the existing 60% thin capitalisation gearing ratio. The impact of moving to a net asset calculation will reduce this gearing threshold even further.

Measurement date for assets and liabilities

The proposal to require quarterly or daily measurement risks imposing significant and unnecessary compliance costs given that the calculation is based on IFRS accounting values which may not be prepared on a quarterly basis. IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. To require these to be done solely for tax purposes at points in the year when they are not already being done for financial reporting purposes imposes additional and unnecessary compliance costs.

Interest rate cap – use transfer pricing principles instead

The discussion paper suggests a bolster to the asset-based thin capitalisation rules in the form of an interest rate cap. This is a novel and untested approach. We consider that the cap on related party loans adds significant complexity, limits flexibility in raising debt capital, increases horizontal inequity between local and foreign-owned businesses and when combined with the reduced debt to asset ratio, makes New Zealand a uniquely complex thin capitalisation regime in the international community. We expect this would result in a higher cost of capital for New Zealand infrastructure assets, resulting in higher charges to end users and/or cost to Government.

The interest rate cap introduces a high risk of double taxation when dealing with jurisdictions that apply transfer pricing principles. The ability to utilise the mutual agreement process in our double tax treaties (MAP) helps avoid double taxation and supports the integrity of the global tax system. While thin capitalisation adjustments have always been unilateral, managing debt levels within the current safe harbour rules has been relatively straightforward. However, the combined impact of the thin capitalisation rules and the interest rate cap will make it much harder to avoid double taxation where interest is not deductible in New Zealand but assessable in the offshore jurisdiction.

These fundamental concerns can be addressed if the interest rate cap is replaced or supplemented by an arm's length debt pricing test relying on transfer pricing rules.

Alternative approaches

Paragraph 2.19 of the discussion paper notes that failure to address the perceived problems with the rules may mean an EBITDA based rule is adopted. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by the discussion paper, there are also a number of problems with the EBITDA approach and as noted above, the OECD recognises that public benefit infrastructure has special characteristics that might mean an exemption from the EBITDA test is appropriate.

In the discussion document "New Zealand's taxation framework for inbound investment" (June 2016), it is noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish". In our view, the imposition of an EBITDA based rule without an exemption for public benefit infrastructure would be at odds with this priority.

Further, in that discussion document the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to income tax...minimising the potential for base erosion by [related party interest] payments" . The OECD 2016 update emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules (which focused on closing a perceived gap in taxation of related party lending) negates the need for New Zealand to consider an EBITDA approach.

We submit that following a series of recent amendments to the deductibility of interest on shareholder loans, the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well supported by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

Implementation concerns

We note that a common theme of recent law changes affecting interest deductions is the New Zealand Government's focus on reducing the use of loans from equity investors. We wish to make Treasury aware that where we have considered proposals to reduce loans from equity investors in response to the law changes, a number of New Zealand tax provisions (e.g. general anti avoidance rule) have had the potential to result in very significant New Zealand tax consequences when such loans are repaid. This is in addition to tax consequences in the foreign investor's home jurisdiction (i.e. realisation for tax purposes of foreign exchange gains due to appreciation of the NZ dollar).

For these reasons, should our earlier comments on the appropriateness of the proposed amendments be put aside, we request that consideration be given to grandfathering existing arrangements given regulated infrastructure investments are large investments made with long term investment horizons based on the policy settings at the investment time, or at the least, providing relief where loans from equity investors are repaid.

General

We trust you find our comments useful. If you have any questions, please contact Warren Knight, Principal - QIC Global Infrastructure on 9(2)(a) [redacted] or at w.knight@qic.com.

Yours sincerely

Ross Israel
Head of QIC Global Infrastructure

Warren Knight
Principal, QIC Global Infrastructure

18 April 2017

Deputy Commissioner, Policy and Strategy
Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Email: policy.webmaster@ird.govt.nz

Dear Deputy Commissioner

Submission on "BEPS - strengthening our interest limitation rules"

We are writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). We appreciate the opportunity to submit on this discussion document.

AMP Capital Investors Limited (AMP Capital) is a Global Infrastructure manager 85% owned by AMP Limited, a company dual listed on NZX and ASX. AMP Capital manages an interest in Powerco NZ Holdings Limited (PNZHL) on behalf of Australian superannuation funds and other institutional investors. PNZHL is the holding company for Powerco Limited, which is New Zealand's second largest Electricity and Gas Distribution Company. Powerco Ltd owns infrastructure assets through which electricity and gas flow to residential customers.

Summary of submissions

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact appropriately highly geared industries such as regulated infrastructure industries.
- This is exacerbated by the inclusion of deferred tax liabilities in the calculation of the deductible debt limit which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity.
- The interest rate cap is a novel and untested approach that may cause inequities at the boundary. It is also unnecessary in light of the current and proposed transfer pricing rules and is inconsistent with internationally accepted transfer pricing requirements.
- In our view, the issue being addressed by the proposed interest rate cap is best solved through the application of the current and proposed transfer pricing rules.
- The proposed changes create an unequal playing field for foreign and New Zealand investors as they have a greater impact on foreign investors, and can harm local New Zealand investors who frequently invest alongside foreign investors.
- The proposed changes may negatively impact valuations of New Zealand assets which can impact both foreign and New Zealand investors.

Background

AMP Capital appreciate that New Zealand needs to ensure that all businesses are subject to an appropriate tax burden. However, in this context, we note the OECD as part of its BEPS project acknowledges that special rules may be needed for infrastructure businesses given their long-term capital intensive nature and public benefit outcome. The proposals suggested in the discussion document however are likely to result in horizontal inequity between businesses based on the residency of their owners and it will have the greatest impact on long term infrastructure businesses especially those with regulated asset bases which are supported by overseas capital. Further, a series of recent changes to the NZ thin capitalisation rules have already significantly reduced the perceived tax benefits that these measures are once again seeking to curtail.

Treatment of non-debt liabilities - Introduction of an arm's length fall back

The discussion document proposes changes in the current thin capitalisation rules to be based on assets net of non-debt liabilities rather than total assets. We consider the existing 60% gearing ratio to be too low for public benefit infrastructure. Powerco's Australasian peers in the regulated transmission and distribution sector have consistently maintained an average gearing above 60%. The impact of moving to a net asset calculation will reduce the total asset ratio even further.

Measurement date for assets and liabilities

The proposal to require quarterly or daily measurement risks imposing significant and unnecessary compliance costs given that the calculation is based on IFRS accounting values which may not be prepared on a quarterly basis. IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. To require these to be done solely for tax purposes at points in the year, or even daily, when they are not already being done for financial reporting purposes imposes significant additional and unnecessary compliance costs.

Interest rate cap – use transfer pricing principles instead

The discussion paper suggests a bolster to the asset based thin capitalisation rules in the form of an interest rate cap. This is a novel and untested approach. We consider that the cap on related party loans adds significant complexity, limits flexibility in raising debt capital, increases horizontal inequity between local and foreign owned businesses and when combined with the reduced debt to asset ratio makes New Zealand a uniquely complex thin capitalisation regime in the international community. In the longer run, we expect this would result in a higher cost of capital for New Zealand infrastructure assets, resulting in higher charges to end users and/or cost to Government.

The interest rate cap introduces a high risk of double taxation when dealing with most other jurisdictions which apply transfer pricing principles. For example, a circumstance could arise where the NZ interest rate cap is 6% while the Australian transfer pricing rules based on OECD principles require an arm's length rate of 8% to be returned as income. This scenario results in the inequitable outcome of the NZ interest deduction being capped at 6% and interest income of 8% being assessable in Australia.

The ability to utilise the mutual agreement process in our double tax treaties (MAP) helps avoid double taxation and supports the integrity of the global tax system. While thin capitalisation adjustments have always been unilateral, managing debt levels within the current safe harbour rules has been relatively straightforward. However, the combined impact of the thin capitalisation rules and the interest rate cap will make it much harder to avoid double taxation where interest is not deductible in New Zealand but assessable in the offshore jurisdiction.

These fundamental concerns can be addressed if the interest rate cap is replaced or supplemented by an arm's length debt pricing test relying on transfer pricing rules.

Alternative approaches

Paragraph 2.19 of the discussion paper notes that failure to address the perceived problems with the rules may mean an EBITDA based rule is adopted. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by the discussion paper, there are also a number of problems with the EBITDA approach and as noted above, the OECD recognises that public benefit infrastructure has special characteristics that might mean an exemption from the EBITDA test is appropriate.

The discussion paper "New Zealand's taxation framework for inbound investment" published in June 2016 noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish"[1]. It our view imposition of an EBITDA based rule without an exemption for public benefit infrastructure risks failing that priority.

Further, in that paper the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to … income tax…minimising the potential for base erosion by [related party interest] payments"[2]. The OECD 2016 update[3] emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is a limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules focused on closing a perceived gap in taxation of related party lending reduces the need for New Zealand to consider an EBITDA approach.

We submit that with series of recent amendments to the deductibility of interest on shareholder loans, the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well supported by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

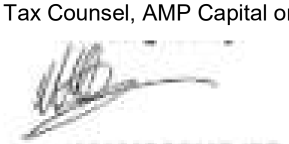
Implementation considerations

A common theme of recent law changes affecting interest deductions is the New Zealand Government focus on reducing the use of loans from equity investors. We wish to make you aware that where we have considered proposals to reduce our level of loans from equity investors in response to the law changes, a number of New Zealand tax provisions (e.g. general anti avoidance rule) have the potential to result in very significant New Zealand tax consequences when such loans are repaid. This is in addition to tax consequences in the foreign investors home jurisdiction (i.e. foreign exchange gains due to appreciation of the NZ dollar).

For these reasons, should our earlier comments on the appropriateness of the proposed amendments be put aside, we request that consideration be given to grandfathering existing arrangements, or at the least, providing relief where loans from equity investors are repaid.

General

We trust you find our comments useful. If you have any questions, please contact Kelly Heezen, Senior Tax Counsel, AMP Capital on 9(2)(a) [redacted] or at kelly.heezen@ampcapital.com.



Michael Cummings
AMP Capital, Head of Australian and New Zealand Infrastructure Funds

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1 Page 3, New Zealand's taxation framework for inbound investment, June 2016
2 Page 15, New Zealand's taxation framework for inbound investment, June 2016
3 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

#010

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18 April 2017

Cath Atkins
Deputy Commissioner, Policy & Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Dear Cath

BEPS - strengthening our interest limitation rules
Submission on the government discussion document

Powerco Limited is writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (discussion document). We are appreciative of the opportunity to provide comments and look forward to discussing the proposals with officials.

By way of background and introduction Powerco Limited (Powerco) is New Zealand's second largest Electricity and Gas Distribution Company, but the largest distributor in kilometres of line. Powerco owns infrastructure assets outside the national grid that electricity and gas flows through to reach residential customers. Powerco is owned via a holding company in New Zealand, Powerco NZ Holdings Limited (PNZHL), which is ultimately owned by five Australian superannuation funds and Queensland Treasury (being a political subdivision of the Queensland Government) via a number of unit trusts and companies.

1. Summary of our submission

The key points of our submission for your consideration are:

- Reducing the effective gearing ratio through the exclusion of non-debt liabilities will unfairly impact highly geared industries such as regulated infrastructure industries and reduce horizontal equity in the tax system;
- This is exacerbated by the inclusion of deferred tax liabilities which in asset intensive industries can be significant and which can be treated by financiers in debt covenants as akin to equity;
- The interest rate cap is a novel and untested approach that may cause inequities at the boundary. We do not accept that an EBITDA based rule is the logical outcome of rejecting the interest rate cap.
- In our view, the issue being addressed by the proposed interest limitation rules is best solved through the application of the current and proposed transfer pricing rules.
- We are supportive of the proposed grandparenting of existing financial arrangements for non-residents acting together.
- Other changes around measurement dates and asset valuations are not practical and contradictory and should not go ahead.
- The implementation date for any of the proposed amendments should be no earlier than 1 April 2019 to allow taxpayers time to restructure, should it be required.

2. Background

2.1 Powerco supports work done by Officials to ensure business are paying their appropriate level of tax, but as a company operating in a competitive environment with regulated returns on assets, it is a poor policy outcome when Powerco is put at a disadvantage simply because it is funded by foreign rather than domestic capital.

2.2 Powerco agrees with the comment at 2.1 of the discussion document “New Zealand relies heavily on foreign direct investment to fund domestic investment”. Powerco agrees that the New Zealand Government should remain committed to ensuring that New Zealand remains an attractive place for non-residents to invest. However, over the last couple of years we have seen through our own mergers and acquisitions processes the ability for various taxpayers/investors into NZ to build in tax efficiencies/inequities into their bid prices. Tax systems should not distort investment choices or discourage foreign investment into NZ.

3. Excluding non-debt liabilities from total assets – adoption of arm’s length test

3.1 The exclusion of the value of non-debt liabilities from total assets effectively reduces the thin capitalisation ratio for most companies to below 60%. The quantum of the reduction will vary, but for very few taxpayers will the impact be small. We do not see change in methodology and intended tightening of the rules as having any connection to BEPS.

3.2 The discussion document relies on international thin capitalisation precedent to exclude non-debt liabilities but does not present the analytical case for their exclusion. Non-debt liabilities are legitimate funding sources for business assets and we do not see the logic in excluding them. Or, put another way, genuine business assets are required by a company to ensure that the obligations represented by non-debt liabilities can be satisfied. Examples 4 and 5 in the discussion document seem to ignore this reality. They are mathematical exercises that are not reflective of the real world. In each example, the directors of the New Zealand subsidiary would be unlikely to approve the suggested dividends as the solvency test cannot be satisfied with dividends at that level.

3.3 The existing 60% gearing ratio is too low for the industry that Powerco operates in. Powerco’s Australasian peers in the regulated transmission and distribution sector consistently maintain an average gearing above 60%. While we recognise that Officials have rejected the identification of specific industries we consider it would be appropriate to introduce an arm’s length test to supplement the safe harbour test. If the nature of an industry supports higher commercial gearing (because it has a quality, long term sustainable asset base and inelastic cash flows) there is nothing offensive in allowing a tax deduction for interest incurred; either external debt or related party.

3.4 Further, we consider that the proposal to effectively reduce the acceptable debt to asset ratio by changing from a total asset to a net asset requirement, if it proceeds should be better designed. In Australia a similar test excludes deferred tax liabilities as they often do not reflect what a debt funder would consider a real liability and can be classified as equity for debt covenant purposes. We submit that a much more considered approach to which non-debt liabilities reduce the total asset base is required and in particular, a deferred tax liability should not be treated as a non-debt liability that would reduce the assets base for safe harbour purposes.

3.5 Both PNZHL and Powerco’s accounts reflect a significant deferred tax liability, the majority of which relates to adjustments required under IFRS on acquisition of the business or change in ownership. The “adjusted deferred tax liability” is not real in the sense that were the group’s assets to be sold (due to a debt default) no tax liability would crystallise (other than an amount of depreciation recovery; but that does not form part of the adjusted deferred tax liability). Banking funders of the group do not consider this as a liability when considering whether to provide finance or not to the group but reclassify it for debt covenant purposes as equity.

3.6 We disagree with Officials’ comments that the impact of this will be small (paragraph 4.27 discussion document). The impact is significant for PNZHL & Powerco, and while it may only impact certain

taxpayers the nature of the adjustments (relating to asset revaluations and uplifts) are such that the impact is likely to be significant when it arises.

4. Limiting the interest rate on related party loans

4.1 We understand the principal concern to be addressed by the introduction of an interest rate cap is a "quality of debt" issue in that Officials consider that some related party loans feature necessary and uncommercial terms which result in excessive interest rates. Officials note that this concern is one of the reasons the OECD favours an interest limitation which links interest deductibility and EBITDA.

4.2 The introduction of an interest rate cap for related party lending is an excessive response to the non-pervasive use of uncommercial terms in relation to related party lending. We accept that those situations may arise and are potentially difficult to resolve under the existing transfer pricing rules but in a discussion document of 3rd March 2017[1] Officials recommend an alignment of the New Zealand transfer pricing rules with those in Australia to the extent that they have regard to the economic substance of the transaction. Reconstruction of transactions which are not commercially rational is proposed (5.40). All of this provides more than adequate legislative ability for the Inland Revenue to deal with the minority of cases where excessive rates are applied.

4.3 In Australia and other jurisdictions that use the asset based test transfer pricing rules are considered adequate to ensure that the lending is commercial. The proposed changes in the New Zealand transfer pricing rules should ensure that New Zealand Inland Revenue has similar level of confidence.

4.4 In addition we note that OECD in "Limiting Base Erosion Involving Interest Deductions and Other Financial Payment Action 4 – 2016 Update" recognise the need to minimise the risk of double taxation and favour a consistent approach between countries to ensure multinationals do not face excessive compliance costs and double taxation.

4.5 The introduction of an interest rate cap is inconsistent with all other countries and the NZ discussion document does not recognise or comment on the resulting double taxation under this method. Furthermore Officials do not acknowledge that NZ has a very different withholding tax environment to Europe and a number of other jurisdictions[2].

4.6 A fundamental principle applied in international taxation is that transactions need to be undertaken on an arm's length basis. Limiting the interest deduction available in New Zealand to the parent's credit rating plus a margin will result in double/over taxation. This is likely to occur when the foreign taxing jurisdiction demands a higher interest rate be charged to reflect the arm's length rate, which will likely differ to the rate under the interest rate cap. We submit that the transfer pricing rules (current and proposed) are more than adequate in dealing with the appropriateness of interest rate charges, are well support by a non-resident withholding tax backstop, and avoid the policy compromises caused by the interest rate cap.

4.7 We understand that thin capitalisation adjustments are typically unilateral but this cap is one sided by design and is much harder to manage than an absolute gearing limit. Furthermore it requires all companies with over $10m related party debt to go through additional compliance even if the gearing levels are well below the appropriate asset percentage.

4.8 Powerco considers that the term of the cap (the restriction of the rate to unsecured debt with a maximum term of 5 years) does not reflect commercial reality in a global context. Powerco submits that a commercial loan may commonly be up to ten years (NZ Government issues 10 year bonds) or at least be based on the borrower's average debt term. We note a number of Powerco's external debt issues are for a period in excess of 10 years, due to the nature of the infrastructure assets

4.9 Powerco's Treasury team have had discussions with our bankers to understand a benchmark rate currently for a 10 year unsecured bond for a BBB and are unable to source a reference rate within the NZ market. Powerco most recently issued debt within NZ for an 8 year period, but to get a NZ

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[1] BEPS – Transfer pricing and permanent establishment avoidance

[2] Para13, page 24 Limiting Base Erosion Involving Interest Deductions and Other Financial Payment Action 4 – 2016 Update

benchmark based on a BBB rating for longer than this we would most likely need to go offshore, which means that for many organisations with longer debt profiles linking the interest rate cap back to the NZ market doesn't align with their external debt portfolio and is artificial in nature.

4.10 Clarification as to the impact of foreign exchange movements on related party debt and how they would apply in relation to the cap is also important (preferably by way of example). We also consider that officials should be clear how they view the use of derivatives (in particular interest rate swaps) and how they tie into the effective related party interest rate calculation for the purposes of the cap. We note that the current rules require revaluation of foreign denominated debt based on the spot rate and fail to take into account any hedging, which can cause significant fluctuations in the group debt percentage and interest expense depending on the exchange rate movement. For most taxpayers with significant offshore denominated borrowings, the debt and all associated payments would be largely hedged so that the taxpayer have a clear understanding of their obligations at each payment date. With the proposed tightening of the measurement rules, a policy solution is required to remove the fluctuations that are distorting a taxpayers true debt percentage and interest obligations.

4.11 We also submit that the ability to add a margin for a parent company credit rating but not for a New Zealand parent credit rating also raises horizontal equity issues. Both should be allowed the margin to ensure that multiple overseas parties from the same jurisdiction face the same economics as a comparable single investor. Tax systems should not distort investment choices.

4.12 Officials note at paragraph 2.19 that failure to address the problems with the rules may mean an EBITDA based rule is adopted. We do not accept that and EBITDA based rule is the logical outcome of rejecting the interest rate cap. As identified by Officials there are also a number of problems with the EBITDA approach. Again, in our view using arm's-length principles under a transfer pricing approach solves these issues and has a much stronger alignment with the core policy principle of preventing excessive related party debt deductions.

4.13 In the discussion document "New Zealand's taxation framework for inbound investment" June 2016, Officials noted that "a priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish". It our view imposition of an EBITDA based rule would fail that Government's own identified priority.

4.14 Further, in that discussion document the Government stated that it considered the use of non-resident withholding tax on related party lending as a "backstop to income tax…minimising the potential for base erosion by [related party interest] payments"[3]. The OECD 2016 update[4] emphasised the difficulty for European jurisdictions in particular to apply withholding tax to interest payments. The EBITDA approach may make some sense in an environment like Europe where there is a limited application of non-resident withholding tax. However, the recent broadening and strengthening of New Zealand's non-resident withholding tax rules focused on closing a perceived gap in taxation of related party lending negates the need for New Zealand to consider an EBITDA.

5. Related Party Debt – Non-residents acting together

5.1 Currently the worldwide debt percentage safe harbour provides that where a group can support external gearing at high levels groups can have an additional level of shareholder debt. We understand that the comments in 5.20 that **any** owner linked debt should be disallowed in the event of gearing levels above 60%, refers only to the proportion of owner linked debt above the 60% level and so have not commented further on that aspect.

5.2 It is Powerco's view that equity investors should be able to take a debt interest in a company if it is at a level that a third party would bank. The tax system should not force investors to take bank debt and give debt margin away. There are legitimate reasons as to why an investor may want/desire equity and debt returns. On this basis Powerco submits that where related party debt is a substitute for third party debt (i.e. it would meet an arm's length debt test) it should remain deductible even with gearing levels about 60%.

[3] Page 15, New Zealand's taxation framework for inbound investment, June 2016
[4] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

5.3 We note that the use of multiple terms around related party lending is confusing and clarification should be provided as to the difference between related party and owner linked debt.

5.4 While this amendment may be seen as improving equity between foreign investors coming into New Zealand directly rather than as part of a collective of investors, there is still inequity in that thin capitalisation rules do not apply to all foreign investors (those co-investing by way of 49% shareholding with a New Zealand resident company for example); there is still a cut-off point. The logic behind just changing this position is not altogether clear.

5.5 Disallowing taxpayers who are deemed to be acting together access to the worldwide group test (for those arrangements not grandfathered or post maturity), also creates inequity for investment into NZ. We appreciate allowing a taxpayer access to the worldwide group test in the case of public private partnerships, but there seems to be no rationale to prevent a group of investors holding an interest in a new business access to the worldwide test, when if the same investment and capital structure had been used by two single foreign investors with a 51%/49% holding, they would have access to the worldwide group test.

6. Other matters

6.1 Officials propose that asset values should be restricted to the value in the accounts (rather than using a value that would be an option under IFRS but is not used in the accounts for various reasons). We consider that the rationale for introducing this restriction doesn’t stack up. It is common and reasonable for Inland Revenue to request accounting and valuation opinions to support the use of different asset values for thin capitalisation purposes in this context.

6.2 To suggest that the independent third parties providing this support would misstate the value and that company officials would be lackadaisical because the numbers are for the Inland Revenue rather than for audited accounts is simply not correct.

6.3 Similarly the suggestion that the measurement date be moved to quarterly or daily is not commercially realistic, and contradicts the assertion above that numbers must be audited to be sensible. Most companies would not prepare IFRS compliant and audited accounts on a quarterly basis. A requirement to calculate thin capitalisation levels this often is simply not meaningful or practical.

7. Implementation Date

7.1 The discussion document notes that if implemented, the proposals will apply from the beginning of the first income year after enactment in most cases.

7.2 The proposed changes will materially impact on Powerco and a number of other foreign owned taxpayers and they should be given an opportunity to get their affairs in order. It takes time and consideration to work through the restructure of an organisation (especially where there is a group of un-related investors deemed to be acting together) to agree a proposed structure, obtain advice both locally and offshore and draft and review documentation prior to implementation. Also given the current tax environment often restructures require a level of certainty from Inland Revenue with regards to anti-avoidance arrangements.

7.3 For the above reasons taxpayers need at least 9-12 months from the time the legislation is finalised to work through these processes and as a result the implementation date for these proposals should be no earlier than 1 April 2019.

8. Concluding comments

We reiterate our concern regarding the breadth of the proposals. In our view, the issues being addressed by the discussion document is best solved through the application of the current and proposed transfer pricing rules combined with an arm’s length debt test.

We would be happy to discuss the matters raised in this submission further with Officials. If you have any questions or would like to discuss any of our comments please do not hesitate to contact me on [redacted] or alternatively [redacted].

Yours faithfully

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Our ref: 170418BEPSIntLimitation

BEPS - Strengthening our interest limitation rules
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

19 April 2017

Dear Madam

KPMG submission on BEPS - Strengthening our interest limitation rules

KPMG is pleased to make a submission on the *BEPS – Strengthening our interest limitation rule* discussion draft (the "Document").

Summary of our submission

Our detailed submissions are attached. In summary:

— We endorse the rejection of an EBITDA based test for limiting interest deductions.

— We do not believe the interest rate cap proposal should proceed. The proposal seeks, in substance, to avoid globally agreed approaches to determining an arms-length interest rate. Any concerns about interest rates on related-party cross border funding should be should be resolved through orthodox transfer pricing analysis.

— If an interest rate cap proposal proceeds, the starting point for the analysis should be the standalone credit rating of the New Zealand borrower, notched up for parental affiliation and credit support, rather than notching down the ultimate parent's credit rating.

— We do not support a deemed maximum loan term of 5 years (or any maximum loan term) for setting interest rates. This is inconsistent with genuine commercial arrangements for which long term funding needs to be secured.

— Taxpayers should be able to rely on year-end values for asset and liabilities for calculating compliance with the debt to asset thin capitalisation safe harbour test. Removal of the year-end valuation option will impose compliance costs on the vast majority of compliant taxpayers for little gain.

In the Document and the accompanying discussion draft *BEPS – Transfer pricing and permanent establishment avoidance* there is an acknowledgement that the transfer pricing issues discussed are complex and resource intensive. We agree. However, the response appears to be legislate away complexity for Inland Revenue, such as with the interest rate cap proposal.

This is not the right approach in our view and risks uncertainty and double taxation for taxpayers (e.g. if the foreign jurisdiction does not accept the NZ interest rate cap as many are likely to). These issues are complex because the underlying transactions involving cross-border goods,

services and financial flows are often complex. Deeming a simple answer does not address the core issues.

Instead, we strongly support Inland Revenue (and Government) investing in additional resourcing to meet these demands. This includes skilled investigators with sound commercial knowledge and transfer pricing experience. Both documents draw extensively on the current practice in Australia. We note the Australian Taxation Office is actively increasingly its resourcing in these complex areas and we believe it is imperative that Inland Revenue does the same.

Further information

Please contact us, John Cantin on (04) 816 4518, Bruce Bernacchi on (09) 363 3288, or Darshana Elwela on (09) 367 5940 if you would like to discuss our submission.

Yours sincerely

John Cantin
Partner

Bruce Bernacchi
Partner

KPMG's detailed submissions on the Document

Chapter 1 – Scope of review

Proposal

The proposals in the Document will apply to both foreign owned firms operating in NZ (i.e. inbound investment) and New Zealand firms with offshore operations (i.e. outbound investment in subsidiaries).

Submission

The proposals should be restricted to inbound investment only, until a considered approach to outbound investment can be developed.

Comment

We consider that the Document's base protection concerns do not exist with respect to outbound investment. For a start, we would expect Inland Revenue to have better information on cross-border funding arrangements where the parent lender is in the NZ tax base. This should allow Inland Revenue to evaluate the relevant transfer pricing risks more easily and efficiently than for inbound loans. This is also consistent with the different safe harbour thresholds, under the thin capitalisation rules, for inbound and outbound investment (where the threshold for limiting interest for outbound investment is higher).

If the proposals do proceed, we submit that inbound investment should be the sole focus of the proposal until a considered approach to outbound investment issues can be developed.

Chapter 2 - The New Zealand approach to thin capitalisation

Proposal

The Document does not consider whether New Zealand should change to an EBITDA-based rule. However, it considers that the current rules are working well and the preferred approach is to address specific problems rather than abandon the general framework

Submission

We agree that the current thin capitalisation approach is appropriate and submits that an EBITDA based rule for New Zealand be explicitly rejected.

Comment

As outlined in the Document, there are significant disadvantages to an EBITDA based test for limiting interest deductions, including the potential for interest deductions to be denied due to poor trading conditions and other factors that are outside the control of the business. In our view the disadvantages of an EBITDA-based rule outweigh any tax base protection advantages. We believe the current NZ group debt thin capitalisation safe harbour test, combined with the 110% worldwide group test, strikes the right balance.

For avoidance of doubt, our support for the current approach does not extend to the interest rate cap proposal in the Document, for the reasons discussed later in this submission. We would however welcome the opportunity to discuss alternative measures to prevent excessive interest deductions being taken against the NZ tax base. In our opinion developing a fair

alternative should be the focus and the introduction of an EBITDA style test should be clearly rejected.

Chapter 3 - Limiting the interest rate on related party loans

Proposal

The Document proposes to cap the deductible interest rate on related party loans from a non-resident parent to a New Zealand borrower based on the credit rating of the parent. The Document explicitly states that this should not apply to outbound (from New Zealand) loans. For ease of reference, we have referred to this as the "interest rate cap" proposal in our submission.

Submission

We do not support the interest rate cap proposal. Interest rates on inbound related-party loans should be determined in accordance with normal transfer pricing principles, with appropriate resourcing of Inland Revenue's transfer pricing capability to resolve difficult issues.

Comment

Unprincipled approach

The justification given for an interest rate cap is that "while in principle transfer pricing should limit the interest rate, these rules are not always effective". This is the extent of the analysis in the Document in support of the interest rate cap proposal. In our view, it is insufficient to justify the implementation of a very blunt instrument.

We submit that the better response is appropriately resourcing Inland Revenue's transfer pricing capability to deal with these and other complex transfer pricing matters, not implementing arbitrary solutions like an interest rate cap. There is nothing to suggest that the relevant concern – high interest rates in conjunction with high gearing – cannot be managed through orthodox transfer pricing principles. This is what Australia and other countries do. The fact that New Zealand will be an outliner if the proposal proceeds – as no other country takes this radical approach to limiting interest deductibility – should be cause for concern.

Further, the interest rate cap is aimed at achieving a transfer pricing result which Inland Revenue already argues for, i.e. pricing inbound related party debt at little more than what a foreign parent can raise debt at has been Inland Revenue's stated position in a number of transfer pricing disputes. However, this has been framed in the Document as being a thin capitalisation measure, when it is clearly not. (Paragraph 3.49 of the Document which confirms the cap will not be subject to general transfer pricing adjustments confirms this – if these were separate issues, transfer pricing should not be impacted by the application of the cap.) This has wider implications, which we discuss below. The cap is at odds with the general tone of the other proposals in the Document, which seek to bring New Zealand further into line with OECD guidance on transfer pricing and the arm's length principle.

Inland Revenue will be able to argue it both ways – i.e. to arbitrarily limit high price inbound debt, while arguing that outbound loans should have normal transfer pricing rules applied (i.e. without an interest rate cap). This is conceptually flawed. It is at odds with the application of the arm's length principle. There should be no distinction in how the arm's length principle applies based on whether the loan is inbound or outbound. In our view, the proposal is unprincipled as a result.

"Dressing up" the proposal as a thin capitalisation anti-avoidance measure does not change the substance of the proposal. It is a derogation from the globally agreed arms-length principles.

This mis-labelling to justify a derogation, amongst other proposals in the BEPS documents, is a worrying trend. It is counter to principles of transparency and certainty.

The interest rate cap proposal echoes the OECD's proposal to allocate the global interest costs of a multinational across the jurisdictions it operates in. That proposal did not proceed because it required re-thinking of fundamental concepts – e.g. allowing deductions in excess of the amount actually incurred in New Zealand (if the allocation basis supports this) or allowing non-arm's length arrangements to allocate interest expense around the global group. For the same reasons that the interest apportionment proposal has not proceeded, the interest rate cap proposal should not proceed.

Double taxation risk

This proposal will naturally lead to a greater risk of double taxation. Foreign lenders will be required, under the transfer pricing laws that apply in their own jurisdictions, to charge an arm's length interest rate. If this rate is higher than what the proposed cap allows as a deduction in New Zealand (which would no doubt be a common occurrence) foreign lenders may be subject to income tax in their home country on the full interest rate charged, but would not be able to claim a full deduction in New Zealand. Further, NZ will also charge non-resident withholding tax on the full interest rate.

Such an outcome is possible under existing thin capitalisation rules, but foreign lenders can mitigate this by not leveraging up their New Zealand operations beyond the NZ safe harbour threshold of 60%. However, with an interest rate cap, any amount of debt funding (over the existing $10 million transfer pricing safe harbour for interest rates) will be subject to the cap, meaning even a relatively small amount of lending can result in a mismatch between global transfer pricing principles and New Zealand's thin capitalisation regime. Further, if the result is driven by a thin capitalisation adjustment in New Zealand, as opposed to application of arm's length transfer pricing principles, this means there is no recourse to Competent Authorities for resolution. This further supports the case for a transfer pricing solution to this issue.

Consistency with Australia and global practice

We note that throughout both the Document, and the accompanying discussion draft "*BEPS – Transfer pricing and permanent establishment avoidance*", there are repeated references to the Australian position. This is generally reasonable as Australia is one of our largest trading partners and comprises the lion's share of New Zealand taxpayers' related party cross border activities. (We have reservations regarding some of Australia's measures, particularly, where they depart from the global consensus – see our deemed PE submissions) However, the interest rate cap proposal is a substantial departure from the Australian position and given the substantial amount of cross border activity between the two nations, there is the very real risk of potential double taxation given the Australian Taxation Office's corresponding position on Australian transfer pricing.

Given the significant degree of co-operation between the Australian Tax Office and Inland Revenue, we would expect that trans-Tasman interest rate pricing issues should be relatively straightforward for the two revenue authorities to resolve using orthodox transfer pricing principles. The prevailing Inland Revenue view, which has been echoed in the accompanying discussion draft *"BEPS – Transfer pricing and permanent establishment avoidance*", is to encourage the use of Advance Pricing Agreements (APAs) to gain certainty. The interest rate cap proposal runs contrary to that view – its aim is to reduce administrative costs for Inland Revenue, at the expense of greater uncertainty and double taxation risk for taxpayers.

Further, a key objective of Inland Revenue's Business Transformation programme is more regular reporting of business information by taxpayers. This should mitigate some of the concerns raised around timely access to information to resolve transfer pricing and other complex tax issues.

Finally, other jurisdictions experience similar challenges, yet none have sought to introduce the concept of an interest rate cap in response to transfer pricing complexity. New Zealand should not be a "leader" in this respect. Particularly, as the introduction of a blunt and "unique" approach for limiting interest deductions is likely to be perceived unfavourably by our trading and investment partners. We believe this is ultimately likely to be detrimental for a small capital importing nation such as New Zealand. New Zealand should be making policy decisions that accommodate and encourage foreign investment, not penalising genuine funding arrangements by imposing arbitrary restrictions on how much interest can be claimed on debt funding.

One of our key competitive advantages is the ease with which companies can do business and the certainty of our tax and regulatory environment. That is, we do not generally do things which are outside of the international norm. We are too small a country to introduce laws that are unique. Where we have tried to be different, this has often been at an economic cost and has required reversion to the norm. The interest rate cap proposal risks a repeat of the original incarnation of our CFC rules, which saw New Zealand's rules described by many as the "Star Trek" approach to international tax reform. That is, the absence of an active/passive distinction in our CFC rules meant we boldly went where no-one had gone before in the design of a CFC regime, supposedly confident that other countries would soon follow. They did not and the regime was belatedly amended. New Zealand needs to learn from that experience.

For avoidance of doubt, we are not saying that BEPS concerns around excessively high interest rates on inbound related-party loans should be ignored. We believe the transfer pricing rules are the appropriate toolkit to deal with such concerns, and our experience with Inland Revenue is that these issues are well litigated in transfer pricing disputes.

The interest rate cap could be used as a safe harbour

While not our preference, the interest rate cap proposal could be included as an additional safe harbour for transfer pricing compliance.

It would reduce compliance costs for taxpayers that elect to apply it, as well as investigative time and effort for Inland Revenue. It would still allow taxpayers the ability to demonstrate that their interest rates are arm's length under normal principles. Not only would this better align the treatment of inbound and outbound debt, it would allow taxpayers to better manage their tax positions in other jurisdictions, and would still enable the use of Competent Authority processes to mitigate the risk of double tax.

Chapter 3 - Cap based on parent credit rating plus an appropriate margin

Proposal

To base the proposed cap on the interest rate that the borrower's ultimate parent could borrow at on standard terms.

The maximum deductible interest rate:

— where the ultimate parent of the borrower has a credit rating for senior unsecured debt, would be the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin.

— where the ultimate parent has no credit rating, would be the interest rate that would apply if the parent raised senior unsecured debt on standard terms, plus a margin.

The allowable margin would be limited to that which could be derived from appropriate bond yields one credit rating notch below that of the senior unsecured rating attributable to the ultimate parent.

Submission

If our above submission that the interest rate cap proposal should not proceed is rejected, the interest rate cap for a borrower that has an identifiable ultimate parent should be determined as follows:

— Step 1: the borrower's standalone credit rating should be determined using a globally recognized credit rating methodology (such as Standard & Poor's) without any account of parental affiliation.

— Step 2 the borrower's credit rating calculated under Step 1 should be increased by up to three notches, up to a maximum of one credit rating notch below that of the ultimate parent.

Comment

Proposal is inconsistent with principles of company law

Using the ultimate parent's credit rating as the starting point to derive an interest rate on New Zealand inbound debt is not desirable, regardless of the inclusion of an appropriate margin.

For a start, it is contrary to company law, endorsed in New Zealand courts, that treats subsidiaries as separate legal entities to their parent. It is in essence "piercing the corporate veil" by deeming a subsidiary to have almost no separate legal existence to its parent company.

More importantly, it implies that the New Zealand subsidiary has a similar business profile to that of the parent, which is often not the case. In general, the New Zealand operations of foreign multinationals are often several multiples smaller and will typically comprise a single function or asset, or at the very most a less diverse set of functions or assets when compared to the ultimate parent.

The existing transfer pricing approach for related party loans used by Inland Revenue, which starts with the borrower's credit rating is more in line with the arm's length principle. Not only does it give regard to the credit quality of the specific borrower, but it provides flexibility to notch the borrower's stand-alone credit rating upwards to reflect the specific circumstances of that company and its position in relation to the wider group. This approach is also more consistent with the credit rating analysis we would expect to see undertaken by a bank or other third party lender in practice. Further, such an approach does not preclude a credit rating being consistent with that of the ultimate parent should the facts and circumstances support such a finding.

Standard & Poor's guidance on credit ratings

Standard & Poor's "*Group Rating Methodology*" considers that no uniform approach exists when assessing a credit rating for a subsidiary in light of its parent's rating. Further, "*…no single factor determines the analytical view of the relationship with the business venture in question. Rather, these are several factors that, taken together, will lead to one characterisation or another*". This expressly indicates that such a "notching" process will depend largely on the facts and circumstances of the multinational in question, and that a uniform one notch downgrade from the parent's credit rating is not consistent with market and arm's length practice.

Further, Standard & Poor's also suggest that for a subsidiary to generally be rated the same as its ultimate parent or one notch below its ultimate parent, the subsidiary must either be considered:

— Core (i.e. integral to the parent group's current identity and future strategy); or

— "Highly Strategic" (i.e. almost integral to the parent group's current identity and future strategy).

Given the relative size of the New Zealand economy, with the possible exception of Australasian groups, generally it would be a gross exaggeration to describe the New Zealand subsidiaries of foreign multinationals as either core or highly strategic.

At best, we believe most New Zealand subsidiaries could be considered "strategically important" under the Standard & Poor's methodology, which describes such entities as *"less integral to the group than high strategic subsidiaries. The rest of the group is likely to provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support."* For strategically important subsidiaries, Standard & Poor's recommends generally increasing the stand-alone credit rating calculated for the subsidiary by three notches.

Further, increasing a subsidiary's credit rating by three notches is also consistent with global jurisprudence and, in particular, the decision in *Canada v. Generic Electric Capital Canada Inc.* ("GE Capital").

We consider that our alternative approach, if the interest rate cap proposal proceeds, will provide a result that is more reflective of arm's length and commercial principles, thereby enabling multinationals to better manage their global transfer pricing positions. In addition, we consider that our submission strikes the appropriate balance in allowing Inland Revenue to manage some of the key issues arising in its transfer pricing financing disputes.

Chapter 3 – Cap for borrowers with no identifiable parent

Proposal

Where a New Zealand borrower has no identifiable parent, the appropriate interest rate cap for related-party debt is to be determined based on the rate at which the New Zealand borrower could issue senior unsecured debt, with no margin.

The Document considers that there are two options to address the concern that the NZ capital structure may be manipulated:

— determine the borrower's credit worthiness based on an arm's length amount of debt, as determined under transfer pricing rules (this is the approach taken in Australia); or

— deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

Submission

If the interest rate cap proposal proceeds, where a New Zealand borrower has no identifiable parent, the appropriate interest rate should be determined with reference to the stand-alone credit rating for the borrower in relation to senior unsecured debt using an arm's length amount of debt.

Comment

We welcome the approach proposed in this instance insofar as it supports an assessment of the cost of borrowing by using the NZ borrower's stand-alone credit rating as the starting point.

We consider that basing such an assessment on an arm's length level of debt, as determined under transfer pricing methodologies, is the most principled approach.

This approach has been endorsed in Australia and, if adopted in New Zealand, would minimise the risk of double tax in the event of dispute. Further, consistent with our comments above, applying an arm's length level of debt is likely to result in the derivation of an interest rate that better satisfies the arm's length test in counter-party jurisdictions, thereby further minimising the potential for double taxation and disputes.

The alternative, treating related party debt as equity even where a NZ subsidiary's total debt (including the related-party debt) is within an arm's length level, is inconsistent with established market practice for establishing the debt capacity of capital structures. Notwithstanding limited exceptions, companies across all industries are funded by a combination of debt and equity. Whether debt is provided by third parties or shareholders should have no bearing as to the arm's length debt level of a company To ignore related party debt is therefore tantamount to taking a position that entities should be funded through equity and/or bank debt only, which is unrealistic.

Further, any assessment by a bank of an appropriate credit rating would take into account their estimate of an arm's length level of debt for the borrower, to ensure that they have adequately captured the borrower's risk of default, as well as ensuring that covenant levels have been appropriately set. As a consequence, observed market practice generally allows for an arm's length level of debt to be factored into any assessment of a credit rating.

Chapter 3 – Guarantee fees

Proposal

Guarantee fees will be limited to the margin allowable under the interest rate cap.

Submission

The treatment of guarantee fee should have regard to our submission above on the calculation of the interest rate cap for borrowers with an identifiable parent.

Comment

The allowable guarantee fee should be set by reference to normal transfer pricing principles. However, per our submission above that the cap should be calculated by reference to the NZ borrower's standalone credit rating being increased by three notches, up to a maximum of one credit rating notch below that of the ultimate parent, the treatment of guarantee fees should follow.

Chapter 3 - De minimis exclusion from the interest rate cap

Proposal

Where all cross-border related party debt is less than NZ$10 million, ordinary transfer pricing rules will apply, allowing a specific margin above the benchmark rate to be used.

Submission

We support the interest rate cap not applying in the above circumstances.

Comment

The de minimis is a sensible compliance cost reduction measure for companies with small amounts of inter-company debt.

Chapter 3 – Application of the General Anti-Avoidance Rule

Proposal

While a specific anti-abuse rule is not proposed, taxpayers breaking loans may be subject to application of the general anti-avoidance rule.

Submission

The application of section BG 1 in these circumstances needs to be carefully considered, as not all loan re-sets will be to take advantage of rising interest rates or borrowing margins.

Comment

The Document notes that breaking a loan may defeat the intention of the proposal and be subject to a section BG 1 challenge by Inland Revenue if done to take advantage of a higher interest rate environment.

Care needs to be taken as there may be genuine commercial reasons why borrowers and lenders will look to refinance early and/or renegotiate loan terms prior to the original maturity date. The general anti-avoidance rule should therefore only be applied where there is a clear purpose of avoiding the interest rate cap proposal.

Chapter 3 - Maximum loan term of 5 years

Proposal

For the purpose of determining the appropriate interest rate on a related party loan, any loans with a term of longer than five years will be treated as having a term of five years.

Submission 1

This proposal should not proceed.

Submission 2

If our primary submission is not accepted, there should be carve outs for:

— long term infrastructure projects, such as debt funding for Public Private Partnerships;

— finance leases; and

— life financial reinsurance.

Comment

While we acknowledge that commercial loans terms generally do not exceed five years, there will be sound commercial reasons for some loans having longer terms. Typically this will be because the loan will be funding an asset or project with a life in excess of five years and security of funding for the asset/project is desirable throughout the entire period. Independent lenders will also generally be willing to lend if the lending is effectively secured against a tangible asset. Therefore, we do not support an artificial requirement for the interest rate to be based on a loan term of 5 years, where the actual term is longer (and potentially significantly longer).

In the event that our principal submission is not accepted, exceptions should be made for infrastructure projects and finance leases.

In the case of infrastructure projects, these are inherently long term (10 years plus) in nature and project owners and operators will want to ensure continuity of funding throughout the life of the project. This is particularly important as the NZ Government is actively pursuing Public Private Partnerships (PPPs) to fund key New Zealand infrastructure needs. To the extent that non-resident capital is required to fund PPP investments, the proposal will simply pass the cost back to Government (and ultimately the NZ taxpayer) as this will impact the rate of return on such projects.

In the case of finance leases, the deemed loan from the lessor to the lessee would be caught by the interest rate cap proposal. Where a finance lease has been entered into on normal commercial terms, pricing of the lease should be able to be undertaken with reference to the actual lease term, rather than a 5 year cap.

In the case of life financial reinsurance, the "loan" term will vary with the performance of the underlying book. Life insurance business and reinsurance is typically written over a long term view of how the policies will perform. A five year limit is uncommercial. (Further, the interest rate will reflect commercial perceptions of risk of the book rather than perceptions of credit worthiness. This further justifies an exclusion.)

Chapter 3 – Consistency of the interest rate cap proposal with New Zealand's tax treaties

Proposal

The interest rate cap is considered consistent with New Zealand's double tax agreements (DTAs) including the articles referring to the arm's length principle

Submission

The analysis in paragraphs 3.58 and 3.59 is contradictory. The proposed cap cannot both be consistent with the arm's length principle and override it.

Comment

Paragraph 3.58 and other parts of the Document state that the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Paragraph 3.59 states that the interest rate cap is a domestic anti-avoidance rule.

However, the interest rate cap cannot both be consistent with the arm's length principle and override it. We consider that it is not consistent with our DTAs.

This highlights the unprincipled nature of the proposal – it is being promoted as something that it is clearly not. This is simply an attempt to justify an override of DTAs.

For completeness, we disagree with the characterisation in 3.58. If this really was the case the interest rate cap would not be necessary. If the interest rate is arms-length it should be deductible. We consider the characterisation at 3.59 to be closer to what is being proposed. However, it is difficult to see the rue as an anti-avoidance rule if the interest rate is arms-length. The "anti-avoidance" label applied by Officials seems to be no more than a complaint that transfer-pricing for related party debt may be difficult. That is not a principled position for the proposals. (See also our transfer pricing submissions.)

Chapter 4 – Treatment of non-debt liabilities

Proposal

Non-debt liabilities (other than interest-free shareholder loans) will be deducted from an entity's gross assets when calculating the thin capitalisation safe harbour test. The result will be that the thin capitalisation safe harbour test will measure assets net of non-debt liabilities.

Submission

Deferred tax liabilities should not be deducted from gross assets.

Comment

We agree that it is appropriate to deduct non-debt liabilities, such as trade credits and provisions, from gross assets in measuring compliance with the thin capitalisation safe harbour test. This would make the calculation more akin to a debt to equity test (which is commonly used internationally) and align more closely with the thin capitalisation regime in Australia.

However, there should be no adjustment for deferred tax liabilities. The Document states that non-debt liabilities can be used to artificially inflate balance sheet gross assets to allow an entity to pass the safe harbour test (e.g. through the use of trade creditors to buy a significant amount of assets just before year end). It provides no support for such a statement. We consider that such a practice is rarely found in practice. There are commercial constraints to such acquisitions. Materially, the company must pay the trade creditors. The concerns are overstated. See further for our comments on the measurement date proposals.

Assuming this concern is valid, it does not exist with respect to deferred tax liabilities. They typically arise due to timing differences between accounting and tax income and expenditure recognition rules and to different assumptions being used for financial reporting and tax purposes. They arise therefore due to the tax rules themselves as opposed to any structuring. They are not a de facto means of financing the ownership of assets. Deferred tax liabilities should therefore be excluded from non-debt liabilities deducted from an entity's gross asset balance.

Chapter 5 – Infrastructure projects controlled by single non-residents

Proposal

Single non-resident investors will be able to breach the 60 percent safe harbour test in respect of third-party funding for infrastructure projects that meet certain criteria.

Submission

While we support the exemption for single non-resident controllers, we believe the exemption should be aligned with that for "non-resident owning bodies".

Comment

Where the NZ investment is by a group of non-residents acting together (i.e. the group meets the non-resident owning body definition), there is presently the ability to exclude third party debt from the application of the thin capitalisation rules. This is without regard to the nature of the underlying investment. We believe the proposed exemption for single non-resident controllers should be similarly broad. (We believe this is further buttressed by the proposal to exclude any related-party debt from both calculations.)

Chapter 5 – Removal of the year-end measurement option

Proposal

Taxpayers will only be allowed to measure compliance with the thin capitalisation safe harbour tests using the average of daily or quarterly values for asset and liabilities. The year-end measurement option will be removed.

Submission

The proposal should not proceed. Taxpayers should continue to be able to use year-end values for assets and liabilities in determining compliance with the capitalisation safe harbour tests.

Comment

The Document states potential abuse of the year end valuation option as justification for its removal. Further, the Document refers to the current specific anti-abuse rule being in-effective.

We are not aware of any specific examples of abuse of this rule, let alone that such abuse is widespread or that Inland Revenue has unsuccessfully attempted to apply the specific rule.

We assume that taxpayers are considered to be "gaming" the rules by, for example, by paying down related-party debt prior to balance date and then re-financing at the start of the following year. We are not convinced that this is an example. The payment would need to be sourced from either debt or equity. If it is debt, the thin capitalisation rules would still apply. If it is equity this is more likely to be long term equity for which no deduction is available. On these assumptions it is difficult to see why the specific rule would apply. If there is more, past history would suggest that Inland Revenue would seek to apply the general anti-avoidance rule to deny interest deductions. It may be able to apply the existing anti-abuse provision.

It would seem to us that strengthening the specific rule rather than penalising the vast majority of (fully compliant) taxpayers with increased compliance costs is a better approach. However, as Officials specific concerns are unclear, we are not in a position to comment on what those amendments should be.

The use of year end values is a pragmatic feature of New Zealand's thin capitalisation rules as it allows taxpayers to use the balances in their financial statements, which they will have already had to produce and in many cases will have been audited. Quarterly or daily management accounts, which would necessarily be what the averaging calculations will be based on, do not undergo the same degree of scrutiny and review as year-end figures for many taxpayers.

Such accounts also do not necessarily apply the full valuation and other judgements that are applied to year-end financial statements. This may under or over value assets at each of these measurement dates. They will provide no more accurate measure than a year end test. The result would be the use of less reliable data or the introduction of costly rules requiring the production of more robust daily or quarterly financial data.

We further note that the proposal to include non-debt liabilities as a deduction to assets will constrain the ability of companies to excessively gear their New Zealand operations. To the extent that, for example, acquiring assets through trade credit at year end is a real concern, that problem is already dealt with by the non-debt liabilities proposal. We consider that the trade-off for that proposal is to retain the year-end valuation option.

#012

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18 April 2017

Hon Steven Joyce – Minister of Finance
Hon Judith Collins – Minister of Revenue

Inland Revenue
PO Box 2198
Wellington 6140

Dear Hon Steven Joyce, Hon Judith Collins,

Plenary's submission on "BEPS – Strengthening our interest limitation rules" Discussion Document

Through our engagement with Dan Marshall and Treasury's PPP unit, we welcome the opportunity to make a submission in relation to Inland Revenue's discussion document around the strengthening of New Zealand's interest limitation rules from the perspective of a long term infrastructure investor. Plenary has reviewed the document and notes the following:

i. Plenary primarily invests in availability infrastructure PPPs which is typically more highly geared than other 'real' asset classes and as such we will always need to consider rules around interest limitation and denial in each specific jurisdiction in which we operate. We positively view the NZ Government acknowledging the need to treat qualifying infrastructure projects as needing a special thin cap rule due to the potential gearing outcomes.

ii. Plenary agrees with 5.7; non-recourse, third-party project financing used in funding infrastructure projects presents minimal risk of BEPS.

iii. A minor comment in relation to 5.10 and 3.8 around the "commerciality" of debt and debt terms specific for infrastructure project investment – infrastructure investments typically have a defined maximum investment horizon, ie the concession term. As such, an infrastructure investor may elect to pay a premium for extending the tenor of debt which de-risks the investment from a refinancing point of view, closer aligning assets and liabilities.

iv. In relation to 5.12 and noting the current framework described in 5.8, 5.9, 5.10, and 5.11, Plenary welcomes the proposed carve-out for infrastructure projects with third-party financing. Reliance on an overarching and blunt instrument such as a worldwide gearing test (at the current threshold) may in some circumstances result in suboptimal outcomes if as a result of interest limitation or denial (as a result of infrastructure related genuine, third-party, non-recourse financing), projects are forced to de-leverage beyond what could be commercially achieved given its risk profile.

   This infrastructure carve-out will address current issues around thin capitalisation in relation to investments controlled by a single non-resident, levelling the playing field and making New Zealand an even more attractive investment destination. It will also ensure New Zealand infrastructure is delivered with optimal capital structures. This proposal ultimately gives

greater flexibility than at present and also assists with the secondary market for equity transfers.

Also in relation to 5.12, we recommend that the proposal should be implemented to ensure Limited Partnerships undertaking a qualifying infrastructure project to be the tested entity rather than tracing through and testing the individual partners comprising the Limited Partnership.

On a connected note, in relation to 5.13 we acknowledge the proposal that the thin capitalisation exemption is limited to third party debt and would not apply to non-qualifying debt such shareholder loans.

v. In response to 5.17, the conditions contained in 5.12 are sufficient from Plenary's point of view to very precisely define the form of project where the proposed carve-out would apply. We do note that the criteria should be should be sufficiently wide to include Local Authorities as well as Central Government.

vi. Further to our above point (v), in relation to 5.15, 5.20, and 5.21, we understand that for a group of non-residents holding a controlling interest acting together are already 'effectively exempt' from thin capitalisation rules. Given the clear conditions proposed in 5.12 and how the proposed carve-out would operate, Plenary's position with respect to infrastructure projects is that for clarity and simplicity of application of intent, the carve-out should extend to all infrastructure projects which meet the conditions in 5.12 irrespective of equity holding structure.

This should not contravene the intention of guarding against BEPS while ensuring government sanctioned infrastructure projects are not incorrectly penalised.

vii. There are instances for infrastructure projects where at the suggestion of the procuring government authority, all senior debt is replaced with the full use of government funding on the basis that the government can borrow at cheaper rates than the private sector. In this circumstance, a superior outcome for government would be achieved if there was no interest limitation on related party non-recourse financing – in the context that the government would be the ultimate beneficiary of a more cost effective offering from the private sector.

Plenary appreciates the constructive steps Inland Revenue is taking to strengthening New Zealand's interest limitation rules in a considered manner with reference to international best practice and guidance, and we see the positions put forward in the Discussion Paper with respect to infrastructure project finance as positive for direct inbound investment into New Zealand.

Please do not hesitate to contact me on 9(2)(a) [redacted] should you wish to discuss our submission further.

Yours sincerely,

Paul Crowe
Executive Director
Head of Origination
Plenary Group

#013

BEPS – Strengthening our interest limitation rules

20 April 2017

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20 April 2017

BEPS – Interest limitation rules
c\- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath,

BEPS – Strengthening our interest limitation rules

CA ANZ welcomes the opportunity to respond to proposals in the Government's Discussion Document on BEPS – Strengthening our interest limitation rules.

We support the Government's work to combat BEPS by reducing the opportunities that allow multinationals to inflate interest deductions artificially and shift profits offshore. Our submissions are aimed at helping the Government ensure the reforms fit within New Zealand's overall tax framework and do not unduly discourage the foreign investment needed for a small capital importing economy like New Zealand.

Striking balance – attracting foreign investment and collecting 'reasonable' amount of tax

The Discussion Document acknowledges that the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest while recognising it is important that firms operating here pay "a fair amount of tax". The Government also considers our current approach to limiting interest deductions is working well but needs to be bolstered by rules to restrict the ability of taxpayers to use excessive interest rates for related party loans.

We commend the Government for not proposing to adopt the OECD recommended approach of using an EBITDA-based rule. In our view an EBITDA-based rule is not appropriate for New

Zealand and the disadvantages of such a rule (such as the loss of interest deductions during periods of poor trading conditions) outweigh any benefits.

However, we have a number of concerns with the proposals raised in the Discussion Document, which, if implemented, could have significant and far-reaching consequences for many taxpayers.

Our principal concern is that the interest rate cap approach is a blunt instrument. Perhaps it is for this reason that only New Zealand appears to be planning to implement such a rule. We are also concerned that the proposal is not accompanied by any analysis or examples of the practical difficulties that arise in the application of the transfer pricing rules, which is the stated justification for the cap. This lack of analysis makes it difficult for us to support the proposed solution.

The Discussion Document notes the transfer pricing rules require taxpayers to adjust the price of cross-border related party transactions so it aligns with the arm's length price that would be paid by a third party on a comparable transaction. We do not think the revised transfer pricing rules should be dismissed as an effective solution. In our view, the revised transfer pricing rules are the appropriate rules for dealing with excessively-priced debt.

The interest rate cap proposals effectively intermingle two policy initiatives. The first is a change to the measurement of debt levels for thin capitalisation purposes and is targeted at the volume of debt on taxpayers' balance sheets. The second is an interest rate limitation which, although framed as such, is not a thin capitalisation measure. It is a transfer pricing measure aimed at the pricing of debt, and is a wholly arbitrary measure, quite inconsistent with the arm's length principle which underpins all other transfer pricing and anti-avoidance rules.

It appears to us that a key driver for this proposal may be lack of appropriate Inland Revenue resourcing for transfer pricing matters. If so, that issue should be addressed directly. An arbitrary attempt to cap New Zealand interest deductions in order to simplify the administrative burden on Inland Revenue at the cost of uncertainty and almost certainly double tax for taxpayers if the cap is disregard by other jurisdictions, as is likely to be the case, is not an appropriate solution.

The Government is proposing to strengthen the transfer pricing rules including by adopting economic substance and reconstruction provisions similar to those in the Australian rules. Given these additional measures and measures in line with other BEPS Actions that address

base erosion issues arising in respect of interest deductibility, we do not believe the interest rate cap approach is needed.

Changes to the measurement of volume of debt

We are also concerned that the proposed changes could affect perceptions of New Zealand as a destination for foreign capital that boosts investment in the economy. One of New Zealand's advantages is the ease of doing business here, which is facilitated by our generally well regarded and certain tax and regulatory frameworks. New Zealand is well regarded partly because it is not seen as being out of step with international norms. The interest rate cap approach will mean New Zealand is seen as being out of step, and, under the current proposals, funding will almost always result in some element of double taxation. This may directly affect foreign investment in New Zealand and increase the cost of capital with any additional funding costs being passed on to local consumers. Furthermore, the proposals will result in double tax becoming mainstream, rather than something that occurs at the margins.

We address the specific issues raised by the interest rate cap proposal in the attached Appendix.

Please note, that given the significant workload on our advisory group members, our submission is of necessity a preliminary response. We may raise other issues once we have had more to consider the detail.

We would be happy to discuss our submission with you and look forward to the opportunity to do so.

Yours sincerely

Teri Welham
Senior Tax Advocate

Paul Dunne
Chair, New Zealand Tax Advisory Group

Appendix

Chapter 2: New Zealand's approach

We agree that the current thin capitalisation approach is appropriate and submit that the EBITDA-based rule is inappropriate in a New Zealand context. The disadvantages to an EBITDA approach as outlined in the Discussion Document convince us that this approach is not appropriate for New Zealand. However, this does not mean we support an interest rate cap approach.

We are concerned that the Discussion Document considers there are only two solutions to address a relatively minor problem for a limited number of firms that borrow from their foreign parents at high interest rates which results in very large interest rate deductions. The Discussion Document agrees that the problem is not the volume of debt but the measurement of the impact of the interest rate (pricing of the debt) which is a transfer pricing issue. In our view it is more appropriate for the interest rate between related parties to be addressed via transfer pricing rules.

We are concerned that the effect of shifting to arm's length conditions for the transfer pricing rules is not discussed. We note Australia has decided it is comfortable relying on its MAAL, arm's length debt and the thin capitalisation rules. The Australian Government also considers it is unnecessary to take any further action in relation to related-party debt. Australia relies on its transfer pricing rules to set the appropriate pricing of debt.

Furthermore, we note that the OECD proposals are not mandatory and they are driven by European interests and principles.

We consider it appropriate for New Zealand to rely on the transfer pricing rules to price related party debt. If debt pricing is a significant issue the Government should increase its investment in, or transfer resources to, the transfer pricing area as part of Inland Revenue's Business Transformation.

Chapter 3: Limiting interest rate on related party loans

Proposal: Is the proposed cap broadly the right approach?

The Government is not convinced that the transfer pricing rules are the most effective way to prevent profit shifting using high-priced related party debt.

Submission

The proposed interest rate cap is not the right approach to address concerns about high-priced related party debt.

Comment

CA ANZ acknowledges concerns that related party loans and interest deductions can be used to shift profits, as can pricing of other related party transactions. However, it seems clear from the available evidence and Inland Revenue's own research that the vast majority of related party debt does not result in base erosion or profit shifting. Most groups use related party debt because this is the easiest and most convenient method of financing business activities.

The comment at paragraph 3.17 that the interest rate cap "should generally produce a similar level of interest expense as would arise in arm's length situations" is concerning and plainly wrong in respect of the interest rate cap methodology proposed.

The notion of capping the borrower's interest rate at the rate that their ultimate parent could borrow at does not reflect commercial reality.

Often the parent and New Zealand subsidiary will be involved in significantly different operations. Generally, the New Zealand operations – functions and assets – will be an order of magnitude smaller than the multinational parent's functions and assets and most likely more constrained. In other words, the subsidiary company's role is likely to be narrower than the parent's. Many New Zealand subsidiaries, by virtue of profitability, industry or country specific or local market factors, will have a much lower standalone credit rating relative to their parent. Intrinsically, the ultimate foreign parent is not the correct benchmark.

Inefficient allocation of capital

As well as additional compliance costs, an interest rate cap could result in an inefficient allocation of capital because:

1. the proposals require parent companies to credit enhance their subsidiaries to one credit rating notch below the parent; or
2. depending on the actual credit rating of the subsidiary, third party debt may be preferred over related party debt even if, under the proposals, third party debt is more expensive than related party debt.

The subtext of the analysis in the Discussion Document, which is unclear in parts, suggests that related parties will include terms and conditions in loans between each other that will have the effect of overstating the interest rate as compared to what an arm's length scenario would provide. There is also a perception by Inland Revenue that, because the interest rate is within the control of related parties, it is a relatively straight forward or simple process to overstate the interest rate. The interest rate cap is seen as a way of addressing those issues without having to consider the appropriateness or otherwise of subordination, or not, of those terms and conditions.

The proposal, at paragraph 5.41 of the Discussion Document "BEPS - Transfer Pricing and Permanent Establishment Avoidance", to amend the transfer pricing rules to refer to arm's length "conditions" will address the issues that the Government is concerned about. We are surprised that this Discussion Document does not consider the effect of the other proposals released at the same time because they will have a material effect on the interest rate. This is what is happening in Australia. The Australian Tax Office is using transfer pricing methodologies to challenge the terms and conditions of related party loans. It also has an arm's length debt test.

In our view the effect of the overall package of measures and particularly the effect of the transfer pricing rule changes will be to obviate the need for the interest rate cap.

Double taxation

CA ANZ is deeply concerned that, as presently formulated, the proposals will give rise to significant elements of double taxation.

We consider the proposal will create a real risk of groups not being able to achieve an appropriate deduction for their related party interest expense and will create the potential for double tax to arise. This double taxation is not at the margins. Rather it will arise in almost all instances where a subsidiary's credit rating is more than one notch below its ultimate

parent company's own credit rating and the loan counterparty is in a jurisdiction with modern transfer pricing rules.

The double tax issue is most likely to arise because a foreign country will require an arm's length interest rate whereas New Zealand will operate to deny a deduction. We suggest consideration should be given to whether an exclusion from the interest rate cap proposals for countries with a modern transfer pricing regime (that could take the form of a grey list or white list) is appropriate. There does not seem much point in denying what is an arm's length interest rate when the other country is going to tax the interest in full.

Single entity

An interest rate cap based on the parent's credit rating seems to assume that a group is in effect a single entity and ignores the fact that groups are made up of separate legal entities, and the transactions between them are real both legally and contractually.

These contractual arrangements will still be taken into account when pricing the loan in the parent's home jurisdiction, under normal transfer pricing principles. As discussed below, given the nature of New Zealand business operations, it is unlikely that a New Zealand subsidiary will enjoy a credit rating one notch below its parent, with the consequence that there may be a mismatch between the New Zealand treatment and the treatment in the parent's jurisdiction.

Compliance costs

The proposal will also add considerable compliance cost to businesses, particularly as the approach proposed, the interest rate cap, is unique to New Zealand. Furthermore, the level of disputes with lender countries is likely to increase, particularly as the New Zealand adjustment will arise under our thin capitalisation rules, limiting the ability for Competent Authority resolution (which would be available if the dispute was in relation to differences in transfer pricing approaches).

Transfer pricing rules

In our view the transfer pricing rules are a better way of tackling the problem than an interest rate cap. The proposals to strengthen the transfer pricing rules should assist with ensuring that excessive interest costs are not allocated to the New Zealand tax base. We question the need for an interest rate cap approach in these circumstances.

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Proposal: Should cap be based on parent credit rating or something else?

To limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower to the interest rate that the borrower's ultimate parent could borrow at on standard terms. That is, where the ultimate parent of the borrower has a credit rating for senior unsecured debt, the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin. Government considers that the interest rate a multinational could obtain is a reasonable approximation of the multinational's cost of funds.

Submission

If the interest rate cap proposal is implemented, logically the parent company credit rating is a starting point. The issue is not so much whether the interest rate cap is based on the parent company's credit rating but which adjustments should be made to that credit rating.

Comment

The proposed approach makes an adjustment based on five year senior debt. The interest rate cap should not be based solely on the parent company's credit rating but on its credit rating and several other factors. An interest rate cap should not be based on only one factor.

In our view, basing the interest rate cap on the parent company credit rating is incorrect. State Owned Enterprises are a good illustration. Under the proposed approach the credit rating of SOEs would be one notch below Sovereign. Based on Inland Revenue analysis the failure of Coalcorp would not have happened. Parent company support is not implicit even in a Government context.

Proposal: What is the appropriate margin?

A margin be added to the interest rate at which the borrower's ultimate parent could borrow on standard terms.

Submission

If, contrary to our submission, the interest rate cap is implemented, the margin should be at least greater than 2 credit notches. Ideally, the margin should accord to debt on arm's length terms and conditions.

Comment

The incoherence of the proposal in a policy sense is demonstrated by the fact Officials have confirmed that, if the situation were reversed, and outbound debt was subject to foreign

interest limitations, New Zealand's expectations will not be influenced and an arm's length amount would be levied on the loan and treated as taxable income in New Zealand. Accordingly, an interest rate cap cannot by definition make an arm's length interest rate unless the company did more to enhance the credit. New Zealand cannot have it both ways.

Design of cap

Proposal: Borrowers with no identifiable parent

When a New Zealand borrower has no identifiable parent, the appropriate cap for related party debt will be determined based on the rate at which the New Zealand borrow could issue senior unsecured debt.

The Discussion Document considers that there are two options to address the concern that a New Zealand company may be loaded with uncommercial levels of debt to push down its creditworthiness:

1. determine the borrower's credit worthiness based on an arm's length amount of debt, as determined under transfer pricing (this is the approach taken in Australia); or
2. deem all related-party debt to be equity for the purpose of determining the borrower's credit worthiness.

Submission

If the interest rate cap proposal is implemented, the appropriate cap for a borrower with no identifiable parent should be based on the rate at which the New Zealand borrower could issue senior unsecured debt using an arm's length amount of debt as determined under the transfer pricing rules.

Proposal: "meaning of related party"

For the purposes of the interest rate cap, a loan that originates from a member of the firm's worldwide group, member of a non-resident owning body or an associated person of the group or body will be treated as being from a related party.

Submission 1

We support the proposed definition of "related party".

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Submission 2

We recommend consideration be given to allowing taxpayers to be excluded from the related party debt rules when a loan is provided on an arm's length basis without any reference to the related party.

Comment

We consider that, because there is no mischief, taxpayers should not be subject to the related party debt rules when a loan is provided on an arm's length basis without reference to the related-party. For example, a parent company is in the business of lending and lends to a related party on the same terms and conditions as a third party without regard to the fact the borrower is related.

Proposal: treatment of guarantee fees

Guarantee fees cannot be greater than the margin allowable under the interest rate cap.

Submission

The treatment of a guarantee fee should be consistent with the approach to setting the interest rate cap.

Proposal: De minimis

To reduce compliance costs for smaller firms, the ordinary transfer pricing rules will apply where the principal of all cross-border related-party loans is less than $NZ10m.

Submission

We support the proposal to include a de minimis. Consideration should be given to increasing the de minimis threshold for countries with a modern transfer pricing regime (that could take the form of a grey list).

Proposal: Override of transfer pricing rules

The interest rate cap will override the general transfer pricing rules.

Submission

We do not support the proposal for the interest rate cap to override the general transfer pricing rules.

If the interest rate cap is implemented, it should be part of the transfer pricing rules, not an override.

Comment

The interest rate cap is not a thin capitalisation measure. Rather it is a transfer pricing measure. We are concerned that the implications of the proposed changes to the transfer pricing rules have not been factored into these proposals.

Proposal: No specific anti-avoidance rule

A specific rule will not be introduced to prevent taxpayers from breaking loans to take advantage of increasing interest rates or borrowing margins. The general anti-avoidance rules could be used.

Submission

We support the proposal not to introduce a specific anti-avoidance rule.

Comment

The proposals are anti-avoidance rules and we do not believe it is appropriate to have a further anti-avoidance rule.

We are disappointed with the way the Discussion Document describes the circumstances in which the general anti-avoidance rule might apply. The example at paragraph 3.51 is not supported by any analysis and does not reflect the hallmarks of anti-avoidance. We would be very concerned if that depth of analysis is sufficient for investigators to raise assessments against taxpayers for changing loans. The example at paragraph 3.51 does not reflect commercial reality when a loan term may be broken to take advantage of a longer term benefit.

Proposal: Maximum loan term

A related-party loan with a term of longer than five years will be treated as having a term of five years for the purpose of determining the appropriate interest rate.

Submission

The proposal should not proceed.

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Comment

The loan term, on which the interest rate is priced, should reflect the commercial conditions underlying the funding arrangement and/or nature of the asset being financed (e.g. infrastructure).

There is no commercial or policy basis for concluding that it is unusual for a commercial loan to be longer than 5 years. We note the following bond issues all have terms longer than 5 years:

- Z Energy
- Genesis Energy
- KiwiBank
- Auckland Airport
- Vector Ltd
- Meridian Energy
- Air New Zealand

Furthermore, certain Government bonds are issued for 10 years or more.

Proposal: No transitional rule

There will be no transitional rule for existing related-party cross border financing arrangements.

Submission 1

The proposal is acceptable for inbound investment provided the application date is sufficiently prospective so taxpayers can reexamine and reorganise their loans and this is expressly contemplated in the legislation and interpretative documents.

Submission 2

The Government should consider carrying out a separate review of the outbound rules.

Proposal: Consistency with New Zealand DTAs

The interest rate cap is consistent with New Zealand's double tax agreements, including articles relating to the arm's length principle.

Submission

We disagree with the assertion that the interest rate cap proposal is consistent with New Zealand's double tax agreements.

Comment

We understand the Government's position is that the interest rate cap proposal is consistent with the arm's length principle or, to the extent it goes beyond a strict application of the arm's length principle, is a domestic anti-avoidance rule and therefore is not subject to our double tax agreements (DTAs). It is plainly evident that these proposals do not create an arm's length interest rate. Therefore the only basis for overriding the DTAs is avoidance. We suggest the proposals are re-examined.

In an environment where there is a significant amount of work being undertaken to address hybrid mismatches that involve double deductions, non-inclusion or double non-inclusion, we do not believe it is appropriate for the Government to put out a proposal that makes double tax more likely than not.

Chapter 4: Treatment of non-debt liabilities

Proposal: assets to be measured net of non-debt liabilities

To require an entity to deduct its non-debt liabilities (e.g. provisions, deferred tax) from the gross asset value.

Submission 1

In broad terms we support the proposal. However, we believe the measurement rules are not correctly defined.

Submission 2

Further more detailed work should be undertaken, with consideration being given to the issues referred to below.

Submission 3

Provisions that do not involve the diminishing of funds, such as deferred tax, should be excluded.

Comment

Paragraph 4.24 implies that the proposal to deduct non-debt liabilities is based on the Australian approach. However, we note that the Australian exclusions that make the rule workable have not been included. We suggest provisions that do not involve the diminishing of funds should be excluded, for example, deferred tax.

We recommend the proposals be examined further. From a public policy perspective, a measurement rule that will closely align arm’s length volume of debt with an organisation’s ability to borrow on an arm’s length basis would be appropriate. We do not consider the proposals achieve that.

We suggest consideration be given to the following issues:

- the effects of the proposal will be uneven across industries. For example, those with high provisions and liabilities, such as distributorships and insurers, will be most affected. We recommend consideration be given to including industry specific concessions to minimise anomalies;

- lenders focus on cash flow as well as an entity's balance sheet. Paragraph 4.11 fails to recognise this issue;
- the valuation of assets will be important because not all organisations are subject to financial reporting rules which allow for and encourage the recognition of intangibles; and
- thin capitalisation is compromised when assets are undervalued.

Finally, we also recommend that the effect of the hybrid proposals be considered when establishing what counts as debt and what does not.

Proposal: No grand-parenting proposed

No grand-parenting for existing arrangements.

Submission 1

The proposal is acceptable provided the implementation date is sufficiently prospective to allow taxpayers to review and rearrange their affairs.

Submission 2

The Government should reconsider the application date, particularly in relation to outbound investments.

Comment

The implementation date could be a 2 year moving average to mitigate the effect of short term fluctuations.

Proposal: Industry specific rules – are they required for insurers, miners, SMES

Specific rules are not necessary for any industry.

Submission

We recommend you consult directly with industries that have significant levels of provisions such as insurance, long term construction, SMEs and 'tech' industries and those entities that have balance sheets that are evolving or based on future cashflows, for example start-ups and crowdsourced activity.

Chapter 5: Other matters

Proposal: De minimis for inbound thin cap phased out same as for outbound

To extend the existing de minimis in the outbound rules so that it applies to inbound entities as, well provided none of the entity's debt is owner-linked debt.

Submission 1

We support the proposal to extend the de minimis rules to apply to inbound entities.

Submission 2

Consideration should be given to simplifying the inbound and outbound de minimis rule to $2m of interest deductions.

Proposal: Infrastructure projects controlled by single non-resident

To allow the 60% safe harbour to be exceeded in relation to public-benefit projects that meet a number of specified criteria, because such projects are considered unlikely to present any BEPS risk.

Submission

We consider the targeted exemption is appropriate but the effectiveness of the proposed exemption will be very dependent on how the exemption will work in practice.

Proposal: Non-residents acting together – restriction

To amend the rules for entities controlled by a group of non-residents acting together. If an entity exceeds the 60% safe harbor, any owner-linked debt will be non-deductible.

Submission

We support the amendment. The amendment will provide certainty to investors.

Proposal: Asset valuations - removing net current value method

To remove the net current valuation method from the list of available asset valuation methods.

Submission 1

We oppose the removal of the net current valuation method.

Submission 2

If more robust valuations are needed, we recommend the net current valuation rules be amended to achieve this objective.

Comment

We believe the removal of the net current valuation method is inappropriate and the reasons put forward are not persuasive. The ability to use net current asset values allows an entity to use a better proxy for the market value of assets if such market values are not reflected in financial statements. Not all taxpayers are subject to financial reporting rules.

The removal of the net current valuation method will

- affect those who do not have cash generating assets on the balance sheet;
- create issues for SMEs;
- add complexity; and
- increase compliance costs.

Proposal: Measurement date for assets and liabilities – removing option to measure on last day

To no longer allow entities to value their assets and liabilities on the last day of their income year. Instead, taxpayers will be expected to value their assets and liabilities either on a daily or quarterly basis.

Submission

We do not support the proposal to remove the option that allows taxpayers to value their assets and liabilities on the last day of the income year.

We suggest that, as an alternative, consideration should be given to allowing taxpayers to value their assets and liabilities based on a moving average.

Comment

The removal of the option that allows entities to value their assets and liabilities on the last day of their income year is impractical. Taxpayers will not want to incur the significant compliance costs involved in measuring their assets on a daily basis for tax purposes. It is also highly unlikely that they will have sufficient information for daily valuation of assets and liabilities.

If Government is concerned about taxpayers bed and breakfasting loans, anti-avoidance rules are more appropriate than increasing compliance costs for all.

Proposal: Remedial re trusts and owner-linked debt

To amend s FE 18(3B) so it operates clearly in relation to trusts.

Submission

We support the proposal to amend s FE 18(3B) to ensure it operates clearly in relation to trusts.

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BEPS – Strengthening our interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

21 April 2017

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Strengthening our interest limitation rules

We support the consultative approach adopted by the Government in its adoption of measures associated with the G20/OECD-led Base Erosion and Profit Shifting ("BEPS") project.

BEPS – Strengthening our interest limitation rules forms part of an interconnected package, alongside *BEPS – Transfer pricing and permanent establishment avoidance* and *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.* The package is a powerful combination, which will put New Zealand at the forefront of worldwide approaches to BEPS implementation.

This submission should therefore be read alongside our submissions on the other elements of the package.

Overall approach to New Zealand's interest limitation rules

Overall, we accept the case for the Government revising aspects of our interest limitation rules, given it has consistently expressed support for the OECD's work.

We do not support the proposed limit on interest rates on related party loans as this will lead to double taxation in many cases and is incompatible with the arm's length principle. The combination of the proposed limit on interest rates and proposed changes to the thin capitalisation rules are a duplication and overreach.

When making final decisions, it is essential for the Government to give weight to the following:

- New Zealand already has robust interest limitation rules, which are in the main well policed by Inland Revenue. EY's study regarding gearing levels shows no evidence that multinational businesses pay less tax than New Zealand owned equivalent entities. We agree it is preferable to put forward specific proposals without abandoning our current framework.
- Any responses should be proportionate to the scale of the problem in New Zealand – that is, only limited reform is required. The Government should consider whether any measures should be targeted at highly geared outliers rather than applying to the vast majority of moderately geared entities.
- The potentially punitive impact on New Zealand taxpayers of an interest rate cap for New Zealand tax purposes only, where such a cap is not respected or reflected in foreign lending territories.

- The need for a coordinated international approach, with New Zealand staying within international norms.

- The interest rate cap methodology has not been adequately considered. It does not take into account currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing.

- The importance of foreign investment for the New Zealand economy, consistent with New Zealand's taxation framework for inbound investment published in June 2016.

- The importance of minimising compliance costs, uncertainty and the potential for disputes over the meaning of any rules or between revenue authorities.

We agree that an interest limitation rule based on the level of interest relative to earnings – typically based on earnings before interest, tax, depreciation and amortisation ("EBITDA") – is not the best approach for New Zealand. The volatility of interest rates, earnings and difficulties associated with loss making companies argue against an EBITDA-approach. We also note that EBITDA-style rules do not work well for commodity based economies, given that New Zealand companies are price-takers in volatile world markets.

Limiting the interest rate on related-party loans

We oppose the implementation of the interest rate cap. Our submissions may be summarised as follows:

- The proposed changes to the transfer pricing rules, including the ability for the Commissioner to reconstruct transactions, will adequately address issues with the pricing of cross-border associated party lending. We consider that the proposed changes to the transfer pricing regime perform substantially the same role that the interest rate cap is intended to achieve, without some of the costs and negative aspects of an interest rate cap outlined below. Accordingly, we would suggest strengthening the transfer pricing rules as a first approach, and consider an interest rate cap at a later date only if the combination of new and existing transfer pricing rules fails to achieve the desired outcome.

- The proposed cap, being a unilateral New Zealand approach to interest rate quantum, will inevitably lead to double taxation for multi-national groups. If the proposals are implemented, the Government will need to substantially increase the resources available to the Competent Authority to deal with a number of mutual agreement procedures ("MAPs") and disputes.

- The interest rate cap will frequently lead to transfer pricing outcomes that are not arm's length and not taken by our treaty partners. This represents a fundamental and, in our view unnecessary, shift in approach from that of alignment and harmonisation in respect of international tax favoured by the OECD and strongly supported by New Zealand.

- The interest rate cap is a novel approach which is untested in other jurisdictions. Given the significance of the other proposed changes, and the extent to which they already address concerns about the pricing of multinationals' debt, we submit that implementation of the interest rate cap should be deferred until the impact of the other proposals has been fully seen.

- The interest rate cap methodology does not take into account the likes of currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing. A good example is a regulated business like an insurer. The ultimate parent senior unsecured five year debt cost is not a proxy for the group cost of borrowing. In such an example, the majority of the group debt has appropriate regulatory recognition, is heavily subordinated and for a long minimum term. Countries such as the United Kingdom are extending, rather than restricting, deductions for such debt.

Further detail is provided in Appendix A, ordered consistently with the discussion document.

Treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities but note:

- This will lead to a material increase in gearing levels for some multinationals, particularly those with large provisions, trade creditors or deferred tax liabilities.

- The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.

- The proposal to move to quarterly, or daily, calculations will increase compliance costs and should not proceed.

- There should be an arm's length debt option as there is in Australia.

- Existing loans have been entered into under current law in good faith and should be grandparented for an extended period.

Further detail is provided in Appendix B.

Further consultation

The consultation period following release of the discussion documents has been short. To that end, our submission is intended to flag issues which we consider require further analysis, and, where appropriate make recommendations on the approach. We look forward to continuing to engage in discussion on the proposals throughout the coming policy-making and legislative stages.
We understand that these submissions may be the subject of a request under the Official Information Act 1982, and consent to the submissions being made publicly available.

We would appreciate the opportunity to discuss our submissions in person. Please contact David Snell (david.snell@nz.ey.com, +64 21 845 361) in this regard.

Yours sincerely

Aaron Quintal

Aaron Quintal
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Appendix A – Limiting the interest rate on related-party loans

Proposal should not proceed (paragraphs 3.1 to 3.16)

> The proposal to limit the interest rate on related-party loans should not proceed as it will lead to double taxation as other jurisdictions will continue to rely on the arm's length principle, and is likely to increase compliance costs.
>
> The combination of the proposed limit on interest rates and proposed changes to the thin capitalisation rules are a duplication and significant overreach. The interest rate cap methodology has not been adequately considered and in many cases is a significantly inaccurate proxy for the group cost of borrowing.
>
> Proposals to strengthen the transfer pricing and thin capitalisation rules will be a better means for ensuring arm's length terms and conditions on related party loans than an interest rate cap.

We understand that the Government has concerns regarding high-priced related party debt, and that transfer pricing rules have in its view not always been effective. In our view, however, transfer pricing rules are ineffective in only a very limited number of cases. These should be better addressed through targeted measures, many if not all of which are proposed in the suggested amendments to New Zealand's transfer pricing rules.

Double taxation is inevitable under the proposed interest rate cap given that this is a New Zealand specific rule applying to cross border arrangements. It will not lead to deductions in line with arm's length pricing. It will frequently, if not always, lead to double taxation as the lender cannot reduce the interest rate below an arm's length amount. Other jurisdictions will see this "thin capitalisation" measure as undermining or positively moving away from the arm's length principle in loan relationship matters and more MAP cases will result.

Of course, a lender could seek to reduce the interest rate charged to the amount determined by the interest rate cap, but may risk that lower interest amount being adjusted by the lender's tax authority as being non- arm's length. We consider this approach by lenders to be unlikely.

The interest rate cap methodology does not take into account the likes of currency differences and in many cases is a significantly inaccurate proxy for the group cost of borrowing. A good example is a regulated business like an insurer. The ultimate parent senior unsecured five year debt cost is not a proxy for the group cost of borrowing. In such an example, the majority of the group debt has appropriate regulatory recognition, is heavily subordinated and for a long minimum term. Countries such as the United Kingdom are extending, rather than restricting, deductions for such debt.

The combination of the above implications produces the risk of deterring inbound investment beneficial to New Zealand.

Transfer pricing is factual and subjective because by nature there is no one answer to the problem it seeks to solve. As the discussion document notes, there are many factors affecting the price of debt, which an interest rate cap would ignore.

It would be more efficient and equitable to rely on robust and updated transfer pricing law and protocols to ensure that commercial levels of debt and terms of the debt instrument are taken into account in debt pricing. We note that this has been the Australian approach and is generally considered to have proven effective.

In our view, none of the arguments provided in the document suggest that the imposition of a wholly arbitrary interest rate cap is the appropriate means to deal with excessively priced related party debt. Capping the interest rate limits a lender's ability to re-coup their cost and earn an appropriate return for risk.

The proposed interest rate cap is neither objective (since it ignores many terms of intercompany loans which may be entirely commercial) nor certain (as it will lead to considerable uncertainty where the result is an interest rate which, from the perspective of the lender, is not arm's length).

Suggested alternative - Proposed transfer pricing and thin capitalisation rules should be given a chance to take effect (paragraphs 3.5 to 3.7)

The document does not discuss in what respect debt is considered to be overly priced into New Zealand.

Our experience is that most inbound related party debt is senior unsecured debt for terms less than five years and genuinely priced at what a bank could lend. Only a small minority of loans would be priced as subordinated debt and/or for terms greater than five years. These loans will generally have longer terms for sound commercial reasons, with investments such as forestry or public private partnerships dependent on long term finance.

Many factors influence the pricing of a loan. These factors are present in both related party and third party lending. Like third parties, related parties often have sound commercial reasons for any "non-vanilla" terms in their loan agreements. The transfer pricing rules allow for some flexibility in pricing what can ultimately be very complex, but commercially rational, third party loans.

We accept that the transfer pricing rules have historically only allowed the Commissioner to challenge whether the amount (being the interest rate) is an arm's length amount (paragraph 3.6). This has limited the Commissioner's ability to challenge other terms of the lending, but will be addressed by the new reconstruction provisions in the updated transfer pricing rules. [1]

It is considered that the proposed amended transfer pricing rules should go a long way to alleviating if not eliminating current challenges around the ability to assess and challenge debt pricing. Such rules should be given a chance to succeed, before introducing a novel instrument in contravention to the arm's length principle. The document highlights the tension between the interest rate cap and transfer pricing at paragraph 3.49: that problem would be eliminated were the interest rate cap not to proceed.

Indeed, we consider there is a risk that the proposed interest rate cap renders the amended transfer pricing rules obsolete in practice with respect to loan relationships. The point being that challenges are naturally drawn to the "path of least resistance" approach of asserting a rate cap over applying improved transfer pricing rules to genuine commercial arrangements.

Related party and third party borrowings compared (paragraphs 3.8 to 3.12)

The Government states that when borrowing in a third party situation there is pressure to drive the borrower to seek to lower interest rates by offering security or not borrowing to an extent such that it will impact credit rating. We have concerns with this approach:

[1] In addition to those conferred by the general anti-avoidance rule, for example those relied upon by the Commissioner in *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

- Inland Revenue tends to argue that security to ensure realisation in case of default makes little difference to the rate offered by a bank.

- Most New Zealand companies have no formal credit rating. Although conscious of their creditworthiness, they will not be influenced by defending a given rating.

- Transfer pricing reforms proposed in *BEPS – Transfer pricing and permanent establishment avoidance* will reinforce the arm's length debt test for pricing purposes. Both the terms and conditions will need to be commercially justifiable.

- Factors increasing the riskiness of a loan between unrelated parties may be less relevant in a related party context, but they are not irrelevant. Transfer pricing allows for these relevant risks to be balanced in a fact-specific way.

- The proposition that "the risks facing a foreign parent investing in New Zealand do not change whether it capitalises its investment with related-party debt or equity" in paragraph 3.10 is not always accurate. Consider for example a parent entity which funds a majority-held New Zealand subsidiary through a mix of debt and equity. There may be other shareholders which own a small parcel of shares as well. The subsidiary also has a range of other debtors which might rank preferentially to the parent's own debt, or might rank after. If the company is later liquidated, the debt is less risky vis-à-vis the equity investment, and the risk associated with the debt will vary depending on its terms, and the relative terms of the debts owed to third parties.

- The document notes that "some related-party loans feature unnecessary and uncommercial terms" (paragraph 3.11). Under the transfer pricing reforms proposed in *BEPS – Transfer pricing and permanent establishment avoidance* the Commissioner could reconstruct such a transaction if it was not commercial.

- The document notes that it can be difficult to challenge arrangements where the taxpayer can identify a comparable arm's length arrangement (paragraph 3.12). However, if the taxpayer can identify a comparable arm's length arrangement, then by definition the taxpayer's arrangement is arm's length.

Compliance costs will increase (paragraph 3.13)

The highly factual and subjective nature of transfer pricing can make the rules complex and uncertain, leading to high compliance costs. While we agree with this statement, we do not see that it leads to an interest cap as the preferred approach. Compliance costs arise for debt structures as for any other transfer pricing arrangements. Royalty transfer prices, for example, can be compliance cost intensive.

The proposed interest rate cap is likely to increase compliance costs. Loans between a foreign parent and a New Zealand subsidiary will now need to be priced twice – once from the perspective of the foreign parent, for which the foreign tax jurisdiction will require an analysis under orthodox transfer pricing principles (i.e., using the New Zealand subsidiary's credit profile as a starting point), and once from a New Zealand perspective using the parent's credit profile as a starting point. An analysis still has to be done to benchmark the interest rate even if the parent has a credit rating. If it does not have a rating, then a rating analysis has to be done. Companies could even choose to obtain a credit rating solely for tax purposes, at considerable compliance cost.

At present a single analysis is done for both borrower and lender to find the arm's length amount.

Moreover, the different interest rates which would result under the two different analyses will in many cases give rise to double taxation, which will only increase the likelihood of disputes with Inland Revenue.

The proposed interest rate cap ignores the specific requirements of several industries

Some industries require a more fact-specific response to pricing their lending than an arbitrary interest rate cap. For example, the forestry industry has a particular requirement for loans extending over a long (but fixed) period. Further, in this industry it is commercial practice to defer cash flows to the end of the loan period (for example, as a Payment In Kind, or "PIK" loan). This can result in a higher interest rate, but is a necessary response to the commercial factors behind investment in forestry (that is, the long time period to forest maturity). The proposed interest rate cap could make these loans untenable and discourage investment on usual commercial terms for the industry.

In other cases, funding may be provided in a form to meet regulatory requirements to hold loss-absorbent capital as a proportion of balance sheet size and risk. Funding in this form may have certain equity-like features relating to loss absorbency and interest deferral which are mandated by regulators. These equity-like features are mandated by regulation, are not designed to deliver profit stripping by way of high interest and are essential in supporting certain capital intensive regulated industries.

Our comments on design issues below should be read on the basis that our primary submission for the interest rate cap not to proceed is declined.

Proposal is based on flawed premise (paragraphs 3.17 to 3.19)

> A cap will not bring interest rates on related-party loans in line with the interest rate the borrower would agree to with a third-party lender.

Our experience is that a New Zealand subsidiary will typically have a credit rating well below (not just one notch below) that of its ultimate parent. The rate at which a New Zealand subsidiary could borrow from a bank is considerably different than the parent's cost of funding, especially in the absence of an explicit parental guarantee. This is why, in the absence of tax, multinational enterprises will often borrow at the parent company level and finance offshore subsidiaries through related party funding.

Interest rate cap based on parent credit rating (paragraphs 3.23 to 3.37)

> An interest rate cap should assume a greater than one notch difference below that of the senior unsecured rating attributable to the ultimate parent. It is difficult to provide any guidance on the appropriate difference as this will vary on a case-by-case basis.
>
> Pricing based on senior unsecured debt does not meet the arm's length standard.

Please note this section is drafted on the basis that an interest rate cap is introduced. Our primary submission is that such a cap should not be introduced given this adopts a one size fits all approach, ignoring the commercial arrangements entered into. Our comments below should not be taken as inconsistent with this primary submission.

We do agree that a hard interest rate cap would not be well-targeted, and does not take account of the facts and circumstances to which an approach through the transfer pricing regime is much better suited. A cap based on parent credit rating is preferable to a hard cap.

However, one notch suggests that the New Zealand subsidiary is "highly strategic" to the group (Standard & Poor's grouping methodology 2013 suggests a highly strategic subsidiary would have a rating one notch below group rating). Standard & Poor's define "highly strategic" as being "almost integral to the group's current identity and future strategy; the rest of the group is likely to support these subsidiaries in almost all foreseeable circumstances". In our experience, very rarely would that be the case for New Zealand subsidiaries. Moody's is even more conservative for notching for this "implicit support" than Standard & Poor's.

The discussion document calls for submissions on what the appropriate margin would be. Assuming that there are at least some subsidiaries of foreign multinationals in New Zealand which could meet the requirements of Standard & Poor's "nonstrategic" category (that is, of "no strategic importance to the group; these subsidiaries could be sold in the near to medium term") then Standard & Poor's guidance suggests these entities are generally rated at their own standalone credit profile and therefore receive no implicit parental support.

Where the shareholder debt into New Zealand is subordinated to actual senior bank debt, it seems unreasonable and not arm's length to price it as senior unsecured debt (paragraph 3.24). A bank loan to the New Zealand subsidiary would invariably price lower than subordinated shareholder debt to the New Zealand subsidiary.

Para 3.25 notes that *"We consider it unlikely that a multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational's cost of debt, since this would lower its overall profits."*

It is worth considering why higher borrowing costs in New Zealand may be justified. The group's cost of borrowing may be lower because, for example, it may have many subsidiaries with low standalone credit risk (for example, in countries with high sovereign credit ratings, or that are consistently very profitable). By contrast the New Zealand entity might be a much higher credit risk; for example, it could be a start-up in a different industry, in a smaller, more isolated market.

If the parent itself borrows from a bank, the bank does not take any less risk. The parent may get a lower interest rate because it has a collection of lower risk investments which will more than offset the risk of the New Zealand investment to the New Zealand bank. The parent is effectively offering collateral greater than just the New Zealand subsidiary, and so there is some diversification of the risk. The group's risk is not representative of the New Zealand subsidiary's risk.

International comparison (paragraphs 3.38 to 3.39)

That no other country has proposed an interest rate cap suggests the cap should not proceed.

We are concerned at this novel approach. A coordinated multilateral approach will be the most efficient way to resolve inconsistencies in cross border taxation: departure from international norms proved unsustainable with regards to our controlled foreign company and foreign investment fund rules.

Treatment of guarantee fees (paragraphs 3.44 to 3.45)

Guarantee fees have commercial value, which should be reflected by the proposals.

A guarantor is taking on real liability, as shown by the impact on the availability and pricing of funds when an explicit written guarantee from a bone fide guarantor is in place.

To ensure this meets the arm's length standard, the OECD Guidelines then recognise that parent is then taking on the credit risk for the New Zealand subsidiary and needs to be remunerated through a guarantee fee.

In other words, that the multinational's cost of funds is lower than what an independent lender would offer the New Zealand subsidiary is no reason to depart from the arm's length standard.

Limiting guarantee fees to the margin allowable under the interest rate cap breaches arm's length principles. The guarantee fee would, in almost all cases, be very small under these proposals given there would only be a one notch difference between the interest rate cap and actual borrowing rate. This has no resemblance to arm's length principles.

We would also welcome comment as to whether the guarantee benefit would be a 50:50 split of the margin, per current practice.[2]

De minimis approach to be retained (paragraphs 3.46 to 3.48)

The de minimis should be increased as a compliance cost reduction measure, perhaps to cover groups where the principal of all cross-border related party loans is less than $20 million.

Retention of the de minimis is welcome as a practical measure. There is a strong case for it to be increased, perhaps to $20 million, if these proposals are to be implemented. In many cases the de minimis position reflects a much higher interest rate than would be achieved under these proposals.

Anti-abuse rule (paragraphs 3.51 to 3.52)

The general anti-avoidance rule should not apply to situations where taxpayers exercise break clauses in loans to take advantage of changing interest rates or borrowing margins.

Taxpayers are entitled to arrange their affairs in such a way as to maximise their commercial outcomes in ways which suit their circumstances. Exercising a break clause in a loan agreement does not amount to tax avoidance.[3]

Transitional rules (paragraphs 3.54 to 3.55)

Existing related-party, cross-border financing arrangements should be exempt from the interest cap for a period of five years following enactment.

The absense of any transitional rule for existing loans would mean that every loan will need to be repriced based on the parent company credit rating for New Zealand tax purposes. It seems unlikely that the lender's jurisdiction would be prepared to accept a lower, non-arm's length, return from investment into New Zealand, unless that jurisdiction does not tax foreign sourced interest income. Double tax is therefore a strong possibility, in addition to the compliance costs of repricing.

We propose an extended transitional period, of perhaps five years, to allow for the majority of existing finance arrangments to reach maturity.

[2] See http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html#11, accessed 18 April 2017.
[3] As discussed with Carmel Peters and Steve Mack on 24 March 2017.

Interest rate cap inconsistent with arm's length principle (paragraphs 3.56 to 3.60)

> The proposed interest rate cap contravenes the arm's length principle. It will not "generally produce a similar level of interest expense as would arise in arm's length situations". It will inevitably lead to double taxation, often in circumstances where arm's length pricing has been implemented.
>
> Nor do we agree it consistent with OECD Guidelines that as a general rule there will be no conflict between domestic anti-avoidance provisions and a DTA. OECD Guidelines take this approach only to the extent that domestic thin capitalisation rules do not create pricing that is below arm's length.
>
> The interest rate cap also appears to be incompatible with our domestic legislation confirming that DTAs override domestic legislation (section BH 1(4)).

Para 3.58 notes that *"the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Consequently it should also be consistent with the arm's length principle"*

We submit that the proposal is not consistent with the arm's length principle.

OECD Guidelines discuss thin capitalisation in the context of Article 9 (Associated enterprises). We interpret the Guidelines to mean that thin capitalisation provisions are not considered to contravene Article 9 (requiring arm's length pricing) provided that they do not go so far as to create pricing that would be below arm's length. That is, thin capitalisation rules approximate arm's length borrowing levels. This rate cap will undermine the arm's length principle in the vast majority of cases and hence will result in other countries raising issues in terms of Article 9 (leading to double taxation and invoking MAP).

We note that the discussion document does not address the issue of New Zealand companies lending to foreign subsidiaries. We understand from our discussions with officials that the Government does not intend to apply the interest rate cap in reverse (i.e., for loans to overseas associated parties, taxpayers are expected to continue to apply orthodox transfer pricing principles and price the loans on the basis of the arm's length standard). This demonstrates the interest rate cap is not aligned to the arm's length standard; the Government is seeking to tax business profits neither in accordance with its international commitments through the OECD nor consistently with its long established framework for taxing the income of foreign residents.

Further, the discussion documents do not propose any limitation on the interest rate paid to *third parties* in New Zealand. According to the arm's length standard, the interest rate paid on related party debt should be aligned to what would be paid to independent third parties. The fact that there could be a different outcome if the New Zealand subsidiary borrows from a bank versus borrowing from related parties indicates that this proposal is not aligned to the arm's length standard.

Further, for many New Zealand companies, the rate at which a bank would lend to the New Zealand subsidiary on a standalone basis can be very different to the parent's cost of funding. We submit that it is wrong to assume that implicit support narrows the gap between parent and subsidiary credit ratings in all cases. A typical approach is for the New Zealand subsidiary to borrow from a New Zealand bank, but have the parent guarantee the debt (to achieve something close to the parent's cost of funds). The fact the OECD endorses the payment of a guarantee fee to the parent in such a circumstance is precisely because an interest rate anchored to the parent's cost of funds is not arm's length.

We anticipate the interest rate cap would be a limit, enacted as domestic legislation, reducing the deduction available in New Zealand to something less than arm's length.
Section BH 1(4) of the Income Tax Act states that double tax agreements have an overriding effect on the Inland Revenue Acts. Given that Article 9 of New Zealand's double tax agreements ("DTAs") requires an arm's length outcome (i.e., "conditions between the two enterprises in their commercial or financial arrangements… differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another"), the proposed interest rate cap is incompatible with section BH 1(4). Has the Government considered how it will ensure the proposal actually has effect? Reliance on the incorrect statement that the interest rate cap will produce an arm's length result is extremely risky.

Such a movement away from the arm's length principle in loan relationship matters represents a significant shift in New Zealand tax policy, where an OECD-aligned, harmonisation approach has generally been favoured in international tax matters. It is considered that implementation of an interest rate cap in the manner suggested necessarily leads to a dilution if not outright rejection of the arm's length principle where related party lending is concerned. New Zealand would effectively have separate rules for loan relationships (interest rate cap) and other intra-group arrangements (enhanced transfer pricing rules aligned with OECD recommendations).

The point made above around double tax should be emphasised here. This is a natural and inevitable result of a territory-specific pricing approach that contradicts that generally accepted in counterpart territories.

Appendix B – Treatment of non-debt liabilities and other matters

Debt levels of foreign-owned multinationals

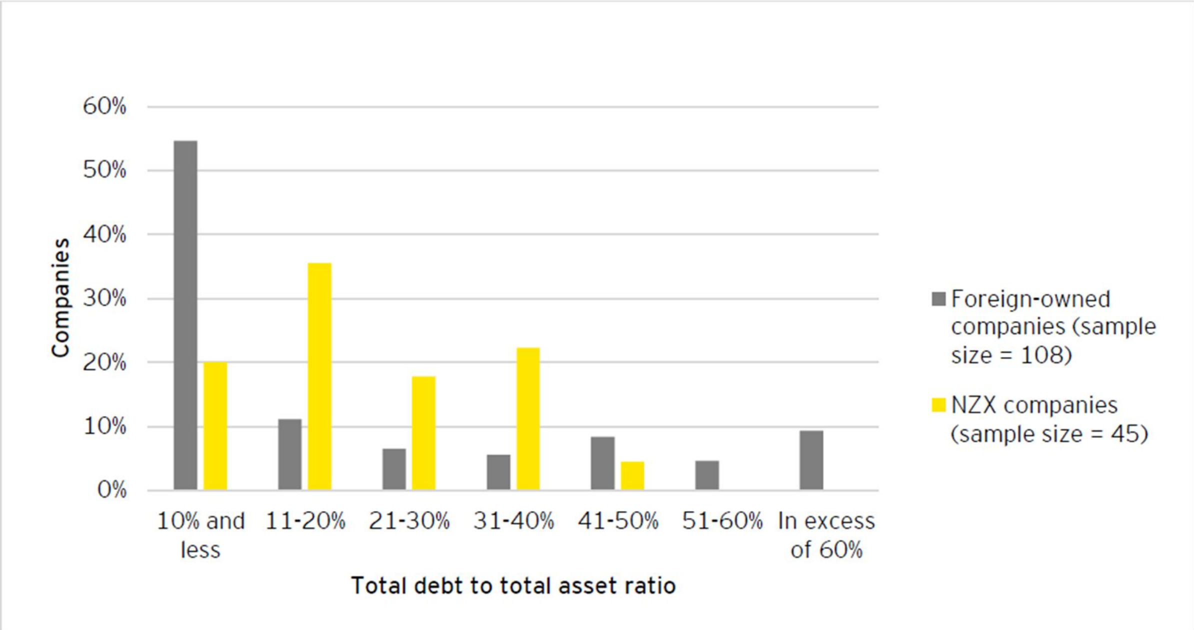
We agree that, in principle, a firm's assets net of its non-debt liabilities is an appropriate base for thin capitalisation rules. The proposals will, however, have a significant effect, with paragraph 4.27 underestimating their impact.

It is important to highlight the current thin capitalisation rules already work well, and that multinationals are mostly moderately geared.

In August 2016, EY released a report, *New Zealand corporate debt levels of foreign multinationals – the elusive case for more tax restrictions?,* which reported EY's market research into the debt levels carried by New Zealand subsidiaries of foreign companies.

Our research shows that most foreign-owned multinationals stay well within the 60% safe-harbour of debt to asset ratio. The average total debt to total asset ratio was just 20%. By comparison, New Zealand based companies also had average total debt to total assets of 20%.[4]

The following chart summarises the results of the analysis.



Our report also considered in more detail whether an EBITDA-style test would be appropriate in New Zealand. Given that the discussion document does not specifically address the practicability of an EBITDA-style test in New Zealand, we do not intend to address this in detail here. Further commentary can be found in our report.[5]

[4] We should note the report is not weighted by entity size. It would be possible for a small number of large, highly geared, outliers to have a material impact on the level of interest deductions claimed. This possibility strengthens arguments for targeted measures rather than wide ranging reforms.
[5] http://www.ey.com/nz/en/services/tax/ey-is-the-tax-crackdown-on-multinationals-justified

In the period since the release of the discussion documents, it has not been possible to undertake an in-depth study on the effects of the proposed changes to the thin capitalisation regime. That said, we have revisited the 108 foreign companies from our 2016 survey and performed a high-level calculation, charting the impact of the new thin cap rules. Our findings can be summarised as follows:

- The debt percentages of all 108 companies increases (where the companies have positive net assets), which is to be expected;

- 23 companies in our sample (i.e., approximately 22% of those surveyed) would be moved from a conservative debt position to an "at risk" debt position (that is, a debt ratio greater than 40%); and

- 11 companies in the sample group (or 10% of the sample) would find themselves moving from inside the safe harbour to now breach the 60% debt level.

The results show that the proposed changes to the thin capitalisation have will have considerable bite.

Non-debt liability definition (paragraph 4.22)

Non-debt liabilities should not include deferred tax liabilities. The definition of interest-free loans requires clarification.

The definition of non-debt liabilities is based on the Australian definition. Deferred tax should be excluded from that definition.

Deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS.[6] Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

We would also appreciate clarification on the definition of interest-free loans as a non-debt liability. Would an interest-on-demand shareholder loan be treated as interest-free?

Grandparenting existing arrangements (paragraph 4.28)

Existing financing arrangements should be grandparented for a period of five years following enactment.

We disagree with the statement that companies will have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time (paragraphs 5.22 to 5.23). This logic applies equally to all multinationals.

[6] Under IFRS entities account for deferred taxes using the New Zealand Equivalent to International Accounting Standard 12 (NZ IAS 12), "Income Taxes." NZ IAS 12 follows a balance sheet approach as opposed to an income statement approach.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature. This is consistent with the proposed application of non-resident withholding tax or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Act. We also note the lengthy transitional arrangements proposed for measures in connection with employee share schemes. The financial impact of disallowing interest deductions can outweigh changes to withholding taxes or the taxation of employee share schemes.

Asset valuations (paragraphs 5.24 to 5.26)

> The ability to use net current asset values allows businesses to use a better proxy for the market value of assets than is sometimes reflected in the financial statements. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained. We see no case for removing an accurate measure of asset value.

We disagree that the valuation method chosen for financial reporting purposes will always be the one that most fairly represents the value of a company's assets (paragraph 5.25). Allowing appropriate values for high value, but hard to value, assets is essential to the working of an asset-based thin capitalisation regime.

Allowing companies to continue to choose to use the net current value of its assets as an alternative to the financial statement values, where this would be allowable under GAAP, appears fair and reasonable. No case has been made for this change.

Experience in Australia suggests that restrictions over the accounting options available regarding asset valuations are of particular concern for industries with substantial intangible assets, where the reported figures in financial statements can significantly underplay an asset's true value. Examples include technology and mining companies.

Measurement date for assets and liabilities (paragraphs 5.28 to 5.30)

> The ability to choose between valuation at year-end, on a quarterly basis, or daily should be retained. The concern around the use of year end calculations is unfounded. An alternative could be to allow the use of the average of opening and closing calculations as is done in Australia.

We have seen no evidence of companies manipulating year-end thin capitalisation calculations. In our experience, often it is not until year-end financial statements are being prepared that thin capitalisation is considered. In the event that a company were to be found manipulating year-on-year calculations then the anti-avoidance rules could be utilised to cover this situation.

In our experience, the daily calculation method is rarely used so in reality the proposal is for quarterly calculations. Reliance on quarterly valuation methods will increase compliance costs. This will particularly be the case for assets requiring formal valuation as part of year-end accounting under IFRS.

Should the Government feel there is a particular problem regarding loans entered into and repaid during the course of the year, it could seek to apply the GAAR and/or develop a targeted extension to section FE 11 of the Income Tax Act 2007. From our perspective, it would be very difficult to envisage an "artificial" year-end balance sheet manipulation structure that achieves a temporary thin capitalisation benefit that would be robust in the face of a challenge on section BG 1 grounds.

Increasing compliance costs for all multinationals to deal with a rare problem which can be targeted effectively by other means is not justified.

Arm's length debt option

There should be an arm's length debt option, as in Australia.

The proposed changes to the thin capitalisation rules largely align the New Zealand methodology with that of Australia. An omission is the arm's length debt test rules that Australian taxpayers can use if their Australian debt levels exceed the safe harbour.[7] The Australian precedent should be followed in New Zealand.

[7] Reviewed in 2015 by the Australian Board of Taxation, which recommended its retention.

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1 May 2017

BEPS – Strengthening our interest limitation rules

Dear Deputy Commissioner

Thank you for the opportunity to comment on the Discussion Document (DD). We appreciate that targeting base erosion profit shifting (BEPS) to ensure multinationals are paying an appropriate level of tax in New Zealand is a key focus for the Government.

We understand that Officials are particularly concerned with excess interest deductions arising from high-priced debt advanced by related parties. As we understand it, the concern arises because of the belief that some multinational groups (MNCs) structure cross-border related-party financing arrangements on non-commercial terms in order to justify a high interest rate being charged under transfer pricing principles, where such terms would not necessarily be available in the context of a third party financing.

In our view a number of the proposals are wider than necessary to deal with this concern, and will significantly increase the compliance burden for taxpayers, including many who currently operate in New Zealand through low risk structures. Officials may not have appreciated the significant adverse effect that the proposals are likely to have on every taxpayer that is subject to the transfer pricing and thin capitalisation regimes.

A summary of our submission points is set out below (all of which we have discussed with Officials in our meetings in recent weeks), with more detail provided in the Appendix:

- a number of the proposals are not in line with the Government's published policy on inbound investment;
- the Government should await the outcome of (a) OECD work on pricing related-party debt, and (b) strengthening the transfer pricing regime, before it decides whether it still wants/needs to introduce an interest rate cap;
- if an interest rate cap is introduced, it should be in the form of a safe harbour in the transfer pricing rules, with taxpayers being given the choice to use accepted transfer pricing principles instead if they prefer (but perhaps with a higher threshold for the taxpayer to satisfy if not using the interest rate cap method);

- the proposed reduction in assets by non-debt liabilities is not needed, and for some industries could have a significant and adverse impact on thin capitalisation capacity. However, if proceeded with, at a minimum the proposed definition of non-debt liabilities for thin capitalisation purposes should contain exceptions for deferred tax and certain other items, similar to the Australian rules;
- the scope of the proposed de minimis exception for inbound investment should be extended;
- the proposed exception to thin capitalisation for infrastructure projects should be implemented, but needs further consideration. A similar exception for securitisation arrangements should be included;
- the ability for taxpayers to use net current asset values for thin capitalisation calculations should be retained;
- measurement of assets and liabilities for thin capitalisation purposes should continue to be able to be based on year end balances. If necessary, it could be altered to be the average of the start of year and end of year values; and
- the application date for any new policy changes should be the income year commencing after 31 March 2019 (or equivalent non-standard tax years) at the earliest.

As discussed with Officials, we would appreciate the opportunity to review and comment on draft legislation before it is released as part of a Bill, if possible, particularly in relation to the interest rate cap proposal, the definition of non-debt liabilities and the use of net current asset values for thin capitalisation calculations.

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely

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Appendix: Detailed submissions

1. General comments

Proposals are not in line with published Government policy on inbound investment

The Government's published policy with respect to inbound investment includes the following:

> "A priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish. Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to New Zealand."[1]

The published policy sets out a framework that should be considered when making changes to tax policy, and emphasises the need to work through any changes carefully to ensure New Zealand's position as an attractive location to base a business is maintained.

We are concerned that some of the proposals in the DD, and the consultation process being adopted, seemingly conflict with this approach. This is for the following reasons:

- certain of the proposals are not in line with current and/or proposed international norms and OECD recommendations;
- a New Zealand solution to high-priced related-party debt is being considered before OECD work on the same issue is completed;
- certain elements of the proposals appear to be poorly designed given inevitability of double tax without any ability to seek relief under double tax agreements (DTAs); and
- the time for the consultation process has been very short (particularly bearing in mind focus of taxpayers on compliance obligations up to 31 March), proposed effective dates of the proposed law change could be sooner than is reasonably practical, and taxpayers risk not being given adequate time to consider and model the effect of the proposals.

Furthermore, there is no discussion in the DD around how NRWT fits with the proposed law changes, even though the policy framework specifically discusses the importance of NRWT in preserving New Zealand's tax base in relation to related-party debt. In a number of scenarios, it seems there will still be NRWT imposed on the full interest expenses, notwithstanding potentially materially larger amounts of that interest expense will be effectively denied under the proposed thin capitalisation changes. We do not consider this effective double taxing is appropriate.

Application date should be no earlier than 1 April 2019

We understand that targeting BEPS is a key focus for the Government and an early effective date for the proposals may be its preference. In our view, the proposed application date should be no earlier than a taxpayer's first income year after 31 March 2019 (or the equivalent non-standard tax year). The changes proposed in the DD will not just affect those few corporates who may be viewed as having

[1] "New Zealand's taxation framework for inbound investment", Policy and Strategy, Inland Revenue and the Treasury, June 2016.

adopted aggressive tax practices but a significant number of additional taxpayers, including those who currently have in place advance pricing agreements (APAs) with Inland Revenue on the pricing of inbound related-party debt. We consider it is reasonable to allow taxpayers time to consider how best to deal with these issues, and to rearrange their affairs in an orderly manner if they decide it is necessary. It will be in the interest of continued foreign investment from overseas to allow properly for this.

2. Limiting interest on related-party loans (DD Chapter 3)

The Government should await the outcome of OECD work on pricing related-party debt and effect of changes to transfer pricing before introducing an interest rate cap

We understand and acknowledge Officials' concerns that the current transfer pricing rules may not be effective to deal with unrealistically high-priced related-party debt, and therefore have proposed the interest rate cap to deal with the issue. In our view, the Government should not introduce an interest rate cap at this stage, given that:

- we expect it is a small number of corporate taxpayers that are engaging in the practices that Officials are concerned about;
- we understand that the OECD is undertaking more work this year in the area of pricing of related-party debt – paragraph 8 of the OECD's Action 4 Paper[2] states that work on transfer pricing guidance for related party financial transactions is being carried out and will be completed in 2017 – this work remains necessary following work already completed under Action 4 (see our further comments on Action 4 below); and
- the Government intends to strengthen transfer pricing rules, (a) to ensure pricing reflects economic value creation rather than strictly reflecting the legal form of an arrangement, and (b) to give Inland Revenue the ability to recharacterise transactions between related parties that would not have been entered into with third parties. To a large extent, the concerns around high-priced debt will be dealt with if the current proposals to strengthen New Zealand's transfer pricing rules are introduced.[3] This is because, following the proposed transfer pricing changes:
  - a loan will be subject to transfer pricing on the basis of its economic substance rather than its legal form where the two differ;
  - a loan will be able to be reconstructed to ensure it is aligned with a commercially rational arrangement that would be agreed by independent businesses operating at arm's length; and
  - the onus will be on the taxpayer to prove the interest rate is arm's length and would have been entered into with a third party.

In our view, the most likely outcome of these changes is that going forward any loans between related parties will no longer have the types of terms that Inland Revenue is concerned are used to justify unrealistically high interest rates. For this reason, and because OECD work in this area is continuing, it

[2] OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update (**Action 4 Paper)**, page 15.
[3] BEPS – Transfer pricing and permanent establishment avoidance – A Government discussion document, Chapter 5 (March 2017).

is too early for the Government to introduce an interest rate cap under our domestic thin capitalisation regime. Furthermore, New Zealand should be slow to adopt a solution that Officials recognise has not been adopted anywhere else globally.

Concerns around unrealistically high-priced debt should be dealt with in the transfer pricing regime as a "safe harbour" and not the thin capitalisation regime

The interest rate cap is proposed as a change to New Zealand's thin capitalisation regime. In our view, the transfer pricing regime and not the thin capitalisation regime is the appropriate place to address this type of concern. This is because the transfer pricing regime is concerned with ensuring that debt is priced appropriately applying the arm's length principle, whereas the thin capitalisation regime regulates the amount of debt that a New Zealand borrower can have. The issue of high-priced debt is a pricing issue and it is therefore more appropriate if it is dealt with in the transfer pricing regime.

In our view, introducing an interest rate cap is a fundamental shift away from the arm's length transfer pricing principle that underpins the pricing of cross border related-party transactions across the world. As part of the BEPS project, the OECD considered alternatives to the arm's length principle to price cross-border related party transactions. However, it was determined that alternative measures, such as a formulaic apportionment, would require development of an international consensus on a number of issues that would be too difficult to achieve. In addition, formulaic apportionment could be subject to manipulation and may result in transactions not being priced according to economic reality. Accordingly, the arm's length principle (adjusted to reflect economic realty and not just solely focused on legal form) was determined to be the most effective and efficient way to price transactions under transfer pricing rules going forward.

However, if New Zealand is to take this formulaic approach to capping related party interest rates, then an interest rate "cap" should be no more than a "safe harbour" available to taxpayers under the transfer pricing regime, which if the safe harbour was applied, would mean that the interest rate on related-party debt would not be challenged by Inland Revenue. This would allow a taxpayer to continue to apply arm's length principles under New Zealand's transfer pricing regime if it exceeds the interest rate cap but the taxpayer takes the view that this can be justified (but perhaps with a higher threshold for the taxpayer to satisfy if not using the interest rate cap safe harbour).

The reasons why we think this approach would be preferable for taxpayers, while still meeting Officials' concerns, are set out below.

(a) Compliance should be simple

Compliance should be made as easy as possible for taxpayers, and costs of compliance should be minimised.

It should be relatively simple to apply the interest rate cap where the ultimate parent has a credit rating, and we can see the superficial appeal of such an approach. However, where a parent does not have a credit rating, establishing the terms on which the parent would have been able to borrow may be very difficult – it will require consideration of a hypothetical situation, based on information outside the control of the New Zealand borrower, and it is likely to be costly and time-consuming for the New Zealand borrower to undertake this exercise.

If the hypothetical credit rating exercise is required to be undertaken in respect of multiple overseas companies (e.g. if the credit rating of main operating company is also required to be determined), the difficulty and compliance costs will increase accordingly.

Introducing the interest rate cap as a safe harbour measure would allow a taxpayer to make a choice as to how to proceed, acknowledging that if it chooses not to apply the interest rate cap safe harbour, it is at increased risk of challenge from Inland Revenue.

(b) The parent's cost of funding may not reflect the New Zealand borrower's true cost of funding

In many cases it may be appropriate for debt of a New Zealand borrower to be priced using the credit rating of its ultimate parent as an approximation for the real cost of funding for the New Zealand borrower. However, there are many situations where parts of a group will have third party borrowing at a higher rate than what the parent would be able to obtain. For example:

- in very large groups, local subsidiaries often effectively operate independently – the parent does not necessarily step in to guarantee debt of all subsidiaries, and banks do not price based on an assumption that a parent would support a failing subsidiary – for example, a client of ours was considered by banks to be a significant credit risk due to solvency issues following a number of previous restructures, and banks were only willing to fund at interest rates that were unacceptably high regardless of the company being part of the large MNC;
- groups may operate through regional hubs – for example, a European group may have an Asian regional group that operates relatively independently and without support from the European group;
- a subsidiary that is not material to the parent or to the group operations overall, and which consequently may have a significantly lower credit rating than the parent, in many cases will obtain third party lending at a higher rate and without parent support;
- the parent may not be a 100% parent – if for example the parent holds 51% and other shareholders have a significantly lower credit rating, a bank is most unlikely to price debt based on the parent's credit rating;
- the subsidiary and the parent may be in different industries, or a subsidiary may operate in only one of the numerous industries of the group – if the industry of the borrower is riskier than the remainder of the group, a bank would charge a higher interest rate;
- taking into account foreign exchange risk and hedging costs may lead to a different commercial decision regarding lending than simply looking at the parent's cost of funds;
- certain industries (e.g. infrastructure) have complex financial instruments due to the nature of the business, which cannot be matched to what the parent's cost of funding would have been.

In these circumstances and others where the New Zealand borrower actually has third party borrowing, this is the best evidence of what the New Zealand borrower's cost of funding is, and interest deductions for related-party debt priced by reference to these actual third party borrowings should be permissible. If an intermediate company in the group has third party borrowing and on-lends to a New Zealand subsidiary this is also legitimate evidence of the New Zealand borrower's true cost of funding and the interest deductions should be permissible.

A taxpayer who decides not to apply an interest rate cap safe harbour and instead apply transfer pricing principles will do so knowing that it faces an increased risk of challenge from Inland Revenue (and potentially a high evidential threshold to support the interest rate). Where a taxpayer does not want to face this risk, it could apply the safe harbour instead. Inland Revenue could gather information from taxpayers as to whether they have applied the interest rate cap or a higher rate by adding a question into the International Questionnaire or requiring the information to be provided through the Basic Compliance Package process. Our expectation is that if this approach were adopted, a significant number of taxpayers would simply apply the interest rate cap. A taxpayer would only choose to apply a higher rate if that the higher rate was clearly justifiable on arm's length principles, in light of Inland Revenue focus on this area and consequential likely scrutiny.

Finally, we note Officials' concerns about the possibility that a New Zealand borrower may be able to borrow excess levels from third parties, thereby lowering its creditworthiness. Our observations in response to this are as follows:

- a third party lender is not going to advance funding to a borrower that the lender does not see as supportable from a commercial perspective, so this alleged concern seems misplaced;
- a bank's lending will be senior to related-party lending so the level of related-party lending will not affect the amount or price at which a bank will lend; and
- the level of third party debt relative to the worldwide group is already dealt with in the thin capitalisation regime.

(c) Risk of double tax should be able to be minimised and relief should be available

A risk of double tax arises in respect of a cross-border financial arrangement where two jurisdictions have rules resulting in interest income and interest deductions that do not match. At present, this risk is mitigated if the two jurisdictions have entered into a DTA – if one jurisdiction increases income based on arm's length conditions, the other jurisdiction must allow for a compensating transfer pricing adjustment.[4] The taxpayers have access to the mutual agreement procedure where they are not satisfied that the relevant competent authorities have applied the DTA appropriately.

We acknowledge that this risk of double tax already exists where interest deductions are effectively denied under New Zealand's current thin capitalisation regime and the same issue would arise with an EBITDA test. However, in these cases, the debt is <u>priced</u> in both jurisdictions by applying the arm's length principle under each jurisdiction's domestic transfer pricing regime and applicable DTA. Accordingly, while we acknowledge that not all jurisdictions will apply the arm's length principle to result in the exact same price for a related-party transaction in all cases, the taxpayer should have the ability to obtain double tax relief under the DTA and to ensure consistency of approach across the 2 jurisdictions.

Introducing the interest rate cap as a transfer pricing safe harbour rather than an absolute rule would still allow a taxpayer who is concerned by this issue to choose to price related-party debt using arm's length principles and accept a higher risk of Inland Revenue challenge and / or tax adjustment. However, the taxpayer will retain access to double tax relief mechanism through the application of the DTA, and through the mutual agreement procedure if necessary.

[4] Article 9, OECD Model Convention with respect to Taxes on Income and Capital.

(d) Adopting the interest rate cap as a safe harbour is consistent with OECD work on Action 4

Allowing taxpayers an option of continuing to price debt on an arm's length basis is consistent with the OECD's work on BEPS involving interest deductions as set out in the Action 4 Paper. In relation to this:

- The OECD noted that thin capitalisation rules limiting the level of debt (as per New Zealand's rules) would need a further mechanism, such as an arm's length test under transfer pricing, to address BEPS concerns where an excessive rate of interest is applied to a loan (paragraph 58). In our view, applying an arm's length test (considering the actual substance of the amount and terms and with the onus on the taxpayer, as per proposed law changes) alongside New Zealand's existing regime, would deal with the issue of excessive interest.
- The OECD appears to have dismissed a rule based on the level of debt plus a further mechanism in favour of the EBITDA approach because such a rule would "add a step to the operation of a rule and increase complexity" (paragraph 58). These are practical considerations rather than any type of acknowledgement that that arm's length pricing is inappropriate as a matter of policy. In New Zealand's context, we already have a rule based on the level of debt that as Officials note is well understood. The concerns raised by the OECD are therefore less relevant for us.
- The OECD expressed a concern (paragraph 12) that interest limitation rules based on arm's length considerations as to the amount and terms of debt (such as the Australian arm's length debt test alternative to their safe harbour, and the UK's equivalent, where in both cases the main focus in applying the rules is on the *amount* of debt rather than the *price* of debt) may not be effective by themselves to prevent BEPS. However, these comments are in relation to a fundamentally different test to the interest rate cap proposals – they are simply saying that an arm's length test on its own does not deal with Action 4 concerns. There is no statement to the effect that using arm's length principles to price debt are not appropriate.

  In fact, the OECD says the opposite – countries may adopt an arm's length test alongside the best practice approach – the amount of interest claimed would be in accordance with the arm's length principle, but this amount is then subject to limitation under the EBITDA approach. This type of approach makes sense because (i) an EBITDA approach is based on <u>net</u> interest expense of an entity, which may borrow under a number of loans and also advance funds - it is not a "per loan" approach, and (ii) an entity that is profitable but lowly geared would not necessarily be subject to any limitation. In both of these situations, a mechanism for pricing each individual loan remains necessary.
- The OECD states that an advantage of an arm's length rule (albeit in a different context as explained above) is that it recognises that entities may have differing levels of interest expense depending on their circumstances (paragraph 12).

Our recommended approach of applying the interest rate cap as a safe harbour, assuming the Government is determined to proceed with some form of interest rate cap (which we do not agree with), would allow for these comments around policy design to be accommodated in appropriate cases. We acknowledge concerns around resource constraints associated with the application of the arm's length principle (although this applies to all cross-border related party transactions so making an exception to just inbound funding does not address the actual resourcing issue). However, as mentioned above, only taxpayers who can clearly justify their position will price using arm's length

terms, and Inland Revenue will be able to easily identify relevant taxpayers, thereby mitigating this issue. Furthermore, in our submission in relation to transfer pricing proposals, we have stated that increased qualified resourcing in Inland Revenue's transfer pricing team is needed.

A taxpayer should be able to obtain certainty through obtaining an APA or a Determination

A taxpayer who decides to price related-party debt based on arm's length principle rather than the interest rate safe harbour should be able to obtain certainty through applying for an APA. Another alternative could be giving taxpayers the ability to apply for a Determination (as permitted in other contexts under the financial arrangement rules) that may be published in a sanitised form.

Interaction with other tax rules and tax treaties needs to be made very clear

Any denial of a deduction should not be considered anti-avoidance which does not benefit from protection under a DTA, unless section BG 1 applies. If the arrangement is challenged under section BG 1, this would be as per the current setting. If Officials' view is that this proposed interest rate cap is an anti-avoidance rule which overrides DTAs, the relevant domestic legislation needs to make it very clear how this is achieved.

Similarly, how any new rule applies in the context of New Zealand's other domestic tax rules around interest deductions should be made clear, and Determinations under the financial arrangement rules will need to be updated.

Maximum loan term for an interest rate cap safe harbour rule should be longer than five years

Many of our clients have third party loan terms of longer than 5 years. Terms of loans up to 10 years are common and in some cases are even longer. Generally speaking, our clients aim to match liabilities with expected life of assets. For example, industries such as forestry, infrastructure and mining tend to seek funding with a term longer than 5 years because the expected life of their important assets is usually over 5 years. Companies seeking funding to invest in manufacturing operations will also often seek long term funding.

From our discussions on this issue, we understand Officials will reconsider what a more appropriate loan term for calculating an interest rate cap may be under the proposals.

Transitional rules will be needed in relation to APAs

A number of taxpayers have spent significant time, effort and costs obtaining APAs from Inland Revenue which include confirmation of interest rates, for the purpose of achieving certainty. Transitional rules for existing APAs should be considered so that New Zealand's attractiveness and perception of political stability regarding taxation of overseas investment is not diminished.

Treatment of non-debt liabilities (DD Chapter 4)

Proposal requiring calculations to include non-debt liabilities should contain exceptions

We do not support this proposed reduction of asset base by non-debt liabilities. We do not think it is necessary and we note that the change will have a significant effect on many taxpayers in types of businesses and industries that traditionally carry higher levels of provisions or other non-current liabilities which do not materially impact on the borrowing ability of the company. Officials should consider the following:

- If the rationale for the changes is to better reflect what a borrower would be able to borrow from a third party, more work is required to determine what the third party would actually take into account. Usually banks will not overly focus on the level of non-debt liabilities unless the relevant creditors have better priority over specific assets than the banks. For example, deferred tax liabilities should be excluded from the calculations, as per the Australian equivalent rules.[5] Some of our clients have significant deferred tax liabilities that should not be relevant to their thin capitalisation position. For example, significant deferred tax balances can arise if (a) companies have valuable intellectual property that is amortised for accounting but not for tax purposes, and (b) in the forestry industry, where asset values grow significantly over years but tax is not due until sale of the trees. There are many more examples. Other liabilities should also be excluded if they are not funding a taxpayer's balance sheet, and other items such as provisions for dividends and preference shares. A number of other types of provisions, while correct from a technical accounting perspective, would have limited impact on the borrowing ability of the company.
- A number of industries are likely to be significantly disadvantaged under these rules – for example, industries with significant rehabilitation requirements or other unique features such as securitisation / securities lending / retirement village arrangements; industries with significant creditor balances and other provisions. If the proposals proceed we recommend that specific carve outs for some of these industries or scenarios will be needed. Retirement village operators, for example, often receive significant non-interest bearing cash deposits from the licences of retirement units (as payment for the right to occupy) but which technically are shown as liabilities on their balance sheet.
- Taking non-debt liabilities into account will introduce volatility to taxpayers' thin capitalisation calculations. The volatility will broadly be equivalent to the volatility recognised as a problem with an EBITDA-based test, and therefore protection from volatility (such as ability to carry denied interest deductions forwards and backwards) should be considered.
- Taking non-debt liabilities into account could put taxpayers into a negative equity position. For example, one of our clients which has recently become subject to the thin capitalisation regime due to the "acting together" rule has negative equity due to a significant deferred tax liability and therefore under the proposals would have all interest deductions disallowed – this does not seem an appropriate outcome.
- Several of the examples in Chapter 4 are not commercial or realistic as they would risk the company failing the company law solvency test.
- To give just a couple of examples of the effect of including non-debt liabilities, one client's current thin capitalisation ratio is 49.5%, and it would become 56.6% taking into account non-debt liabilities, even though the company is not particularly highly leveraged and all debt is third party bank debt. Another client's ratio would move from 40% to 93%, if the proposal for asset values (discussed below) is also adopted.

[5] Income Tax Assessment Act 1997 – section 820-682.

Other matters (DD Chapter 5)

Scope of proposed de minimis exception for inbound investment should be extended

We support the introduction of a de minimis for inbound thin capitalisation rules. However, the proposal to introduce a de minimis in cases where there is no owner-linked debt is unlikely to be useful in practice. The de minimis should instead apply to all cases where the inbound thin capitalisation rules apply. This would be in line with the OECD's proposals as referenced in the DD.

Carve out for infrastructure projects with third party funding needs further consideration

We support a proposed carve out for infrastructure projects. However, further consideration should be given to the following:

- there may be situations where the asset holding entity is different, but related to, the funding entity, e.g. a limited partnership holds the assets and a related party entity secures the required third party funding. The exception should still apply providing that the third party funding is on-lent to the related entity (even though technically the funding may be owner-linked debt);
- the entity will generally not own the asset at the end of construction phase, so how the proposals as to valuation of the assets will need to take into account the service charge the entity has received;
- the rate should apply to an offshore infrastructure entity that is globally funded by third party borrowing where it can allocate funding to a New Zealand infrastructure project;
- an exemption should be included (similar to Australia) for securitisation vehicles and arrangements which by their nature are highly geared.

Ability to use net current asset values should be retained

We understand Officials are concerned that asset valuations used for thin capitalisation purposes but not for financial reporting purposes may not be subject to a reasonable level of independent valuation or scrutiny. We understand this potential concern, but as we have discussed with you, it could be addressed in ways other than restricting asset values to those included in financial statements. The DD, at paragraph 5.25 states "…we consider that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets".

This is incorrect. Your Tax Information Bulletin: Volume Seven, No.11, Page 19 (March 1996) correctly said (when the thin capitalisation rules were first introduced) – "…it is recognised that the valuations for financial reporting purposes are likely to have been adopted for other than tax reasons". Consequently it was concluded that a taxpayer should be able to use net current value if that taxpayer could have adopted it for assets under GAAP (now IFRS) but has chosen not to.

Net current values (or fair value) are permissible under IFRS 13 but taxpayers instead choose not to adopt them for financial reporting purposes for non-tax reasons. These reasons include:

- in the context of worldwide groups that prepare consolidated accounts at the ultimate parent level, groups choose not to go to the additional expense of preparing entity accounts in the New Zealand group on a net current value basis and instead simply adopt historical cost;
- many entities within a group are not required to prepare individual entity financial statements;

- using net current value for financial reporting purposes can give rise to volatility in earnings ratios presented to shareholders which companies prefer to minimise, even though the changes in market value of the assets is a fact of life.

If the ability to use net current value is not retained, taxpayers will, for tax reasons, adopt net current value for financial reporting purposes despite it making no sense for commercial reasons. This change of accounting policy in financial statements under IAS 8 can be made (i.e. it is elective) if the result is more reliable or relevant. This will particularly be the case when there is a significant difference between historical cost and fair value.

As we have discussed with Officials in our meetings, we strongly submit that the ability to use net current values for thin capitalisation purposes needs to be retained.

Officials' concerns could be addressed by requiring valuations being adopted for thin capitalisation purposes to be supported by a valuation from a registered valuer, or a similarly qualified independent person.

Measurement of assets and liabilities should continue to be able to be end of year values (but perhaps average of start of year and end of year)

We understand Officials' concerns that the value for an asset or a liability can be manipulated if a value at a single point in time is used. We think this concern is already dealt with by the existing specific thin capitalisation rules regarding temporary differences. But if this is not enough then as we have discussed with you, continuing to be able to use year end values is very important, and a proposal that the average of opening and closing values is used would be more acceptable. This is preferable to quarterly or daily measurement because:

- the majority of taxpayers currently have no other need to value assets and liabilities quarterly or daily – the increased compliance burden and financial cost that would be imposed in obtaining such values (which often are only properly determined at year end) should not be underestimated;
- valuation outside the financial reporting cycle is inconsistent with the proposal referred to above that values used in financial statements should be used; and
- some balance sheet items are only measured annually – for example, asset impairment – it would not be possible to properly take these into account if measurement was required quarterly or daily.

Outbound thin capitalisation rules

Further consideration regarding the potential impact under the outbound thin capitalisation rules for New Zealand groups (especially SMEs and emerging fast growth businesses). If they have to apply most of these proposals, then the impact and compliance costs could be very material to New Zealand groups which the New Zealand Government should be wanting to support.

#016

AMP CAPITAL

27 April 2017

BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir/Madam

Submission on Discussion Document: BEPS – Strengthening our interest limitation rules

The following submission has been prepared by AMP Capital Investors (New Zealand) Limited (AMP Capital New Zealand) on the Discussion Document: BEPS – Strengthening our interest limitation rules. AMP Capital New Zealand is a specialist investment manager that manages a number of funds that are Portfolio Investment Entities (PIEs), as well as private equity investments. Our submission focuses on the potential affect of the interest limitation proposals contained in the discussion document on some of the investments that we manage on behalf of investors.

Background

New Zealand has a broad base, low rate tax system with limited exceptions. We understand what you are trying to achieve which is ensuring that the New Zealand tax base is protected and non-residents pay their fair share of tax here, as appropriate. However, the necessity to collect tax from non-residents needs to be balanced with the fact that New Zealand is heavily reliant on foreign direct investment and must remain an attractive place for non-residents to invest[1].

The proposals outlined in the discussion document will affect non-residents investment into New Zealand. In particular as they create tax mismatch and a high risk of a double taxation impact. This in turn will affect investor's returns. Non-resident investment in New Zealand is highly likely to reduce post investor's returns being impacted. Our comments on the proposed approach and the specific interest limitation proposals set out in the discussion document are detailed below.

Overall approach

The proposed interest rate cap is a unique approach and is uncalled for due to the recommended strengthen transfer pricing rules. The overall outcome of the interest rate cap proposal for inbound entities (New Zealand entities owned by non-residents), is a potential tax mismatch and a high risk of double taxation. This is best outlined through an example;

- A New Zealand company has a loan from its Australian owner,
- In New Zealand deductions are available to the company for the interest on the loan, say at 5% under the proposed interest cap,
- In Australia the non-resident owner is required to use an arms length interest rate under its transfer pricing rules, say at 7% which is returned as income,

There is a tax mismatch between the jurisdictions and double taxation of 2% as outlined above. The double taxation will affect the non-resident's shareholders or investor's returns from their investment. There is also the unknown factor of what actions will be undertaken in the non-residents owners' jurisdiction by its tax authority for the effect of the interest rate cap in New Zealand. The purpose behind

[1] Page 4, point 2.1, Discussion document – BEPS – Strengthening our interest limitation rules

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the BEPs actions was to eliminate these types of international tax issues or mismatches not potentially create them.

There is no comment in the discussion document about how outbound investment (New Zealand entity with an offshore subsidiary) would be treated. Do they continue to use the arms length basis for transfer pricing, if yes how is this justified given the proposed interest rate cap for inbound investment?

Further, if introduced the interest rate cap will create inequity between New Zealand entities owned by New Zealanders and those owned by non-residents due to the double taxation outlined above. We expect that this inequity would result in reduced future non-resident investment in New Zealand. This would cause a higher cost of capital for New Zealand entities and infrastructure projects. These results are at odds with the statement made that New Zealand is heavily reliant on foreign direct investment and must remain an attractive place for non-residents to invest[2].

Marginal cost of debt

The statement "at the very least the marginal cost of debt should be no more than the marginal return from further investment" has been made in point 2.7 of the document. Where is the back up or justification for this statement? Is this some sort of economic theory or does this occur commercially?

Effectiveness of transfer pricing rules

It has been stated in the document that we are not convinced that the strengthened transfer pricing rules will prevent profit-shifting through the use of high-priced related party debt[3]. Has an exercise been undertaken to:

- Determined the scope that would be available for related parties to use high priced debt under the proposed amended transfer pricing rules, and
- Modelled the actual risk, if any, and
- Considered solutions for removing any scope available for the use of high priced debt?

Further, it has been stated that it is difficult to challenge a high level of related party debt loaded into a New Zealand subsidiary which depresses a subsidiary's credit rating and is used to justify a higher interest rate, as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and similarly high interest rates[4]. If taxpayers can find commercial comparatives for transfer pricing purposes that match their circumstances, would this not point to the fact that commercial lenders are not just undertaking the pure third party financing, which your proposals refer to. If this is the case, are these proposals creating an artificial environment which does not mirror actual commercial reality?

Interest cap

We reiterate that in our view the proposed interest rate cap is a novel approach and it is unnecessary due to the recommended strengthen transfer pricing rules. The overall outcome of the interest rate cap proposal creates inequity between New Zealand entities owned by non-residents and those owned by New Zealanders. In the future we expect that this inequity would result in reduced non-resident investment in New Zealand which would cause a higher cost of capital for New Zealand entities and projects.

It is proposed that the cap on the interest rate is based on what the borrower's ultimate parent could borrow at on standard terms. The details are light on how an ultimate parent would be determined. We question whether it's appropriate to use the ultimate parents borrowing terms approach as:

- in large groups the parent entity can be a number of entities removed from the New Zealand entity,
- the ultimate parent entity could have a different risk profile to the New Zealand entity, and
- either the parent or the borrower entity or both could be subject to rules, regulations or restrictions which affect their borrowing profiles.

It is suggested that where an ultimate parent is controlled by a non-resident owning body then the interest rate cap will be based on the rate the New Zealand borrower could issue senior unsecured debt on

[2] Page 4, point 2.1, Discussion document – BEPS – Strengthening our interest limitation rules
[3] Page 8, point 3.7, Discussion document – BEPS – Strengthening our interest limitation rules
[4] Page 9, points 3.11–3.12 Discussion document – BEPS – Strengthening our interest limitation rules

standard terms. Limited comments have been made on what is a non-resident owning body. Thus it is difficult to determine if non-resident private equity investors or managed funds would fall within the non-resident owning body concept and the possible impacts of this. Further, there would be a cost for taxpayers subject to this approach in determining what their interest rate would be.

It has been proposed that related party loans with terms longer than five years will be treated as having a five year term when determining an appropriate interest rate[5] due to it being unusual for commercial loans being committed for longer than five years. We have experience of commercial loans being written for periods of longer than five years. If applied, this rule would unfairly penalise New Zealand borrower entities through capping the terms of related party debt to an artificially determined period of time.

Infrastructure projects

We support the proposal that an entity can exceed the thin capitalisation 60% safe harbour ratio for infrastructure projects. However, the exemption should be extended regardless of whom controls the entity that is a single non-resident or multiple non-residents. Infrastructure entities generally require large amounts of capital which cannot necessarily be funded by one non-resident owner. Often potential non-resident owners such as managed funds will be restricted in amount they can invest or lend due to their investment guidelines, so more than one non-resident investor may be required.

Non-residents acting together

There is a proposal to change the way the thin capitalisation rules applying to entities controlled by a group of non-residents acting together. For such entities, where they exceed the 60% safe harbour any non-resident owner-linked debt will be non-deductible[6]. What is the reason behind denying interest on owner-linked debt where the 60% threshold is breached? Surely any denial of interest should be linked to the proportion of the breach, rather than making it all non-deductible.

Measurement date for assets and liabilities

It is proposed that the measurement periods for assets and liabilities for thin capitalisation would be the end of each quarter or the end of every day in the income year[7]. This approach would introduce significant costs for taxpayers subject to these rules, in relation to systems required for the calculations and obtaining the appropriate data. Generally systems that produce daily calculations such as unit pricing for the managed funds are complex and costly. Further, the IFRS accounting data e.g. fair valuing of assets, needed for these calculations are commonly not produced quarterly or daily. To require this information only for tax purposes would impose a significant cost and burden on taxpayers. We recommend that the current ability to measure assets and debts on the final day of an entities income year is retained.

Please feel free to contact the writer on [redacted] if you would like to discuss any of the points outlined above.

Yours sincerely

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[5] Page 16, point 3.53, Discussion document – BEPS – Strengthening our interest limitation rules
[6] Page 26, Discussion document – BEPS – Strengthening our interest limitation rules
[7] Pages 29-30, Discussion document – BEPS – Strengthening our interest limitation rules

#017

27 April 2017

By email

C/- Deputy Commissioner, Policy and Strategy
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SUBMISSION: BEPS – INTEREST LIMITATION RULES – A GOVERNMENT DISCUSSION DOCUMENT

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document "BEPS – Interest limitation rules" (March 2017) ("**Discussion Document**"). We would be happy to be contacted to discuss any aspect of the submission.

1.2 In summary, our submissions are:

General comment

(a) There have been a number of reforms over the past few years that will have increased the effective tax rate on foreign direct investment into New Zealand. These include broadening the scope of (and reducing the safe harbour threshold under) the thin capitalisation rules, and broadening the scope of NRWT (and reducing the availability of AIL). Consideration should be given to whether measures that will further increase the rate of effective tax (such as those proposed in the BEPS discussion documents released in March 2017, including the Discussion Document) are appropriate, particularly given New Zealand's headline corporate tax rate is now relatively high by international standards, at a time when there is a tendency towards corporate tax rate reductions by many countries.

(b) The measures proposed in the BEPS discussion documents include layers of overlapping measures, which seek to address the same perceived problem in multiple different ways. The proposed interest rate cap is an example of this, in that it addresses the same concerns as would be addressed by proposed amendments to the transfer pricing rules. Adopting multiple measures to address the same concern results in unnecessary complexity and increased compliance costs which will likely be a barrier to investing in New Zealand.

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Limiting the interest rate on related-party loans (Chapter Three)

(c) New Zealand should not adopt an earnings-based (eg, EBITDA) interest limitation test. Such a test would result in significant volatility and uncertainty for taxpayers.

(d) The proposed interest rate cap should not proceed, but instead consideration should be given to adopting a safe harbour. It is critical that any interest rate cap be adopted as a safe harbour only, because if not, the interest rate cap:

(i) would be inconsistent with OECD transfer pricing principles and transfer pricing rules applied in other jurisdictions, and could therefore result in double taxation (where New Zealand denies a deduction under the cap, but there is no corresponding reduction in the amount of interest income subject to tax in the lender's jurisdiction);

(ii) would make it difficult for certain entities (such as banks and insurance companies) to comply with regulatory capital requirements;

(iii) would have the perverse consequence that the borrower could raise debt at a higher price from third parties than from a related entity. This in turn could result in the tax system driving commercial behaviour (since businesses would have an incentive in cases to incur a higher pre-tax cost under borrowings from an unrelated party (because that cost is fully deductible) whereas borrowing from a related party may have a lower pre-tax cost but a higher after-tax cost due to being only partially deductible); and

(iv) would, contrary to what the Discussion Document proposes, require grandparenting provisions for existing arrangements.

Each of these concerns could be addressed by adopting the interest rate cap as a safe harbour.

(e) If the interest rate cap is adopted as a safe harbour, it should be buttressed by other measures to increase certainty. In particular:

(i) the existing safe harbour credit margin published by Inland Revenue (which applies where a group of companies has cross-border related-party debt totalling less than $10m principal in the relevant year) should be retained; and

(ii) for loans having a principal value below a certain monetary threshold, Inland Revenue could publish (and periodically update) tables setting out safe harbour guidance as to the credit spread that corresponds to each possible credit rating and tenor, to assist in applying the interest rate cap.

Treatment of non-debt liabilities (Chapter Four)

(f) The proposed adjustment for non-debt liabilities will effectively result in a reduction in the permitted debt-to-assets percentage. Officials

should take this into account in any analysis undertaken to determine the overall impact of proposed reforms on the tax burden imposed on foreign investment in New Zealand.

(g) Taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating total assets and total debt for thin capitalisation purposes.

(h) RPS and deferred tax liabilities should be excluded from "non-debt liabilities". (In the case of deferred tax, both deferred tax liabilities and deferred tax assets should instead be excluded from total debt and total assets, respectively.)

Other matters (Chapter Five)

(i) The net current valuation method should not be removed from the list of available asset valuation methods. If officials are concerned that net current values adopted under this method are inaccurate, rather than removing the method, a requirement to obtain an independent valuation when applying the method could be introduced.

2. GENERAL COMMENT

2.1 A number of reforms have been introduced over the past few years which have the effect of increasing the effective tax rate on foreign direct investment into New Zealand. These include broadening the scope of (and reducing the safe harbour threshold under) the thin capitalisation rules, and broadening the scope of NRWT (and reducing the availability of AIL). The question that now arises is the extent to which any further reform to New Zealand's international tax rules is required, and if so, how it should be implemented.

2.2 As Inland Revenue and the Treasury have acknowledged (see "New Zealand's taxation framework for inbound investment: a draft overview of current tax policy settings" (June 2016) at page 3):

> A priority for the Government is ensuring that New Zealand continues to be a good place to invest and for businesses to be based, grow and flourish. Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to New Zealand.

2.3 This passage highlights that tax reform can hamper foreign investment in two ways: first, if the effective tax rate is too high (ie, too much tax is collected), and second, if the tax laws are poorly designed (ie, the tax is collected in an inefficient or economically distortionary way).

2.4 Careful consideration should be given to how the reforms proposed in the BEPS discussion documents released in March 2017 (including the Discussion Document) will perform, judged against each of these two criteria:

(a) With respect to the first point, consideration should be given to whether measures that will further increase the rate of effective tax are appropriate given New Zealand's headline corporate tax rate is

now relatively high by international standards, at a time when the general trend is rate reduction.

(b) With respect to the second point, the measures proposed in the BEPS discussion documents include layers of overlapping measures, which seek to address the same perceived problem in multiple different ways. The proposed interest rate cap is an example of this, since it would address the same concerns as are being addressed by proposed amendments to the transfer pricing rules (in particular the proposed power to align the rules with economic substance, to allow reconstruction of transactions and to refer to arm's length conditions as well as to the arm's length amount of consideration).

These measures reflect similar amendments that have been made to Australia's transfer pricing rules. Experience in Australia (see in particular the decisions of the Federal Court and more recently the Full Federal Court in the *Chevron Australia* case) suggests that concerns regarding high-priced debt can be addressed under the transfer pricing rules. Australia does not have and is not proposing a cap that would limit deductible interest expenditure to an amount that is less than an arm's length amount. For the reasons given below, New Zealand should not adopt such a rule either (or should do so only as a safe harbour).

3. LIMITING THE INTEREST RATE ON RELATED-PARTY LOANS (CHAPTER THREE)

First submission: interest rate cap should be adopted as a safe harbour only

Overview

3.1 New Zealand should not adopt an earnings-based (eg, EBITDA) thin capitalisation test (which would create significant volatility and uncertainty). The proposed interest rate cap could be adopted, but as a "safe harbour" only.

3.2 It is critical that the interest rate cap be adopted as a safe harbour only, because if not, the interest rate cap:

(a) would be inconsistent with OECD transfer pricing principles and the rules of other jurisdictions, and could therefore result in double taxation (where New Zealand denies a deduction under the cap, but there is no corresponding reduction in the amount of interest income subject to tax in the lender's jurisdiction) (see paragraphs 3.6 to 3.21 below);

(b) would make it difficult for certain regulated entities (such as banks and insurance companies) to comply with regulatory capital requirements (see paragraphs 3.22 and 3.23 below);

(c) would have the perverse result that the borrower could raise debt at a higher price from third parties than from its parent (see paragraphs 3.24 to 3.30 below); and

(d) would, contrary to officials' assertion, require grandparenting provisions for existing arrangements (see paragraphs 3.31 to 3.33 below).

3.3 Adopting the interest rate cap as a safe harbour would alleviate the above concerns, by allowing a borrower to pay and obtain deductions for a higher rate of interest than that given by the cap if it can show that in its particular circumstances the arm's length rate of interest exceeds the cap. At the same time, it would retain many of the potential advantages of a cap (by providing an incentive to taxpayers to price related party debt conservatively in order to reduce uncertainty and potential disputes with Inland Revenue).

3.4 Any concern that (if the interest rate cap is a safe harbour) taxpayers could seek to adopt a rate exceeding an arm's length rate can be addressed under the transfer pricing rules. Reforms to those rules have been proposed in a separate discussion document ("BEPS – Transfer pricing and permanent establishment avoidance" (March 2017)) ("**TP and PE Discussion Document**"). We submit that the proposed changes to the transfer pricing rules (subject to our comments in our separate submission in respect of that discussion document) are sufficient to address the concerns officials have with the use of high-priced debt.

3.5 If required, the safe harbour could be buttressed by additional procedural protections for Inland Revenue. For example, taxpayers that do not follow the safe harbour could be required to make a disclosure in their returns so that Inland Revenue is on notice in respect of debt being priced over the cap.

Interest rate cap is inconsistent with OECD transfer pricing principles and with New Zealand's double tax agreements

<u>Inconsistencies between interest rate cap and OECD transfer pricing principles</u>

3.6 The proposed interest rate cap is inconsistent with OECD transfer pricing principles, because it would take no account of:

(a) the relationship between the ultimate parent and the subsidiary in the particular case (instead assuming that a "one-size-fits-all" adjustment, such as a one notch downgrade, is appropriate in all cases due to implicit credit support from the parent);

(b) the actual terms of the related-party debt, including subordination, convertibility, tenor (where exceeding five years) and other terms allocating risk between the borrower, lender and third parties; or

(c) other relevant circumstances, for example, the fact that the subsidiary may have a different asset base or be in a different industry (and accordingly have a different risk profile) to that of the ultimate parent.

3.7 With respect to the first point (implicit parent credit support), international transfer pricing practice recognises that the differential in credit risk between a parent and a subsidiary will be a matter of fact and degree. This is confirmed in one of the leading cases (the Canadian Federal Court of Appeal's decision in *The Queen v General Electric Capital Canada Inc.* [2010] FCA 344). The Court in that case rejected the argument that implicit support from the parent company meant that an explicit guarantee had no value.

3.8 The proposed interest rate cap would assume that in all cases the New Zealand subsidiary's assumed credit rating should be the same as that of its parent (less a "one-size-fits-all" adjustment, such as the one notch downgrade proposed). This would be inconsistent with the reality (recognised in the *General Electric Capital Canada* case) that there is no one size fits all approach, and that the facts and circumstances must be considered in each case to correctly determine the arm's length rate for the relevant arrangement.

3.9 With respect to the second point (that the proposed interest rate cap would disregard the actual terms of the related-party debt), OECD transfer pricing guidance makes clear that, other than in exceptional cases, pricing should be based on the terms of the actual transactions undertaken (OECD Transfer Pricing Guidelines for multinational enterprises and tax administrations, as amended by the BEPS Actions 8-10 2015 Final Reports entitled "Aligning Transfer Pricing Outcomes with Value Creation") ("**OECD TP Guidelines**") at [1.123]):[1]

> The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. **Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured**. …
>
> [Emphasis added]

3.10 The OECD TP Guidelines also indicate that every effort should be made to "ensure that non-recognition is not used simply because determining an arm's length price is difficult" (at [1.122]). On the face of it, that is what the interest rate cap seeks to do.

Consequences of inconsistency with OECD transfer pricing principles

3.11 If New Zealand adopts the interest rate cap (otherwise than as a safe harbour), and as a result denies deductions for interest on debt that is determined in accordance with OECD transfer pricing principles, this would result in double taxation, as the lender would not be entitled to a reduction in interest income in the jurisdiction in which its income is taxable.

3.12 It would also result in New Zealand breaching its obligations under the "Associated Enterprises" articles (typically Article 9) in its DTAs. Article 9(1) of the OECD Model Tax Convention reads:

> Where

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1 The amendments set out in the BEPS Actions 8-10 2015 Final Reports entitled "Aligning Transfer Pricing Outcomes with Value Creation" were approved for incorporation into the OECD TP Guidelines by the OECD Council on 23 May 2016: see http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm (accessed 19 April 2017).

> a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly.

3.13 The proposed interest rate cap would breach this article because it would result in New Zealand including in the profits of the borrower, and taxing, amounts in excess of those which would accrue if its related party transactions were priced in the same way as transactions between independent enterprises.

3.14 The Discussion Document argues that the interest rate cap would not breach New Zealand's DTAs either on the basis that it is a "thin capitalisation" rule which "aims to approximate a similar overall level of interest expense for a taxpayer as would arise in arm's length situations" (paragraph 3.57) or that, to the extent going beyond a strict application of the arm's length principle, it is a "domestic anti-avoidance rule" which is permitted to override New Zealand's DTAs (paragraph 3.59).

3.15 We do not agree with this analysis. The proposed interest rate cap is neither a thin capitalisation rule nor a domestic anti-avoidance rule:

(a) The proposed cap is not a thin capitalisation rule, because thin capitalisation rules (including the EBITDA rule) determine the overall permissible levels of debt or equity funding of an entity, whereas the interest rate cap instead addresses the *pricing* of a *particular* loan.

(b) The proposed cap is not a domestic anti-avoidance rule, because anti-avoidance provisions require some threshold to be met so that the provision applies to transactions having tax-induced features altering the incidence of tax in some way (whereas the proposed interest rate cap is subject to no such threshold).

Rather, the proposed cap is simply a transfer pricing rule, but one that produces results inconsistent with OECD transfer pricing principles and is therefore inconsistent with Article 9 of New Zealand's DTAs.

3.16 The fact that the proposed cap would breach Article 9 is illustrated by two extracts from OECD commentary set out below.

3.17 The first relevant OECD commentary is the report entitled "Thin Capitalisation" (adopted by the OECD Council in November 1986 and published in OECD Model Tax Convention on Income and on Capital 2014 (Full Version) (Vol II, OECD Publishing, Paris, 2014) R(4)-1). This report indicates that thin capitalisation rules ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit (at paragraph 77):

… the question whether Article 9 may inhibit the operation of … thin capitalisation rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this. One group of countries takes the view that where a provision similar to Article 9(1) is included in the convention, it simply prohibits an adjustment of the profits of the resident company to any amount exceeding the arm's length profit. Another group of countries takes the view that while Article 9(1) permits the adjustment of profits up to the arm's length amount it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. A third group, while accepting that there is an absence of such a prohibition in the language used, nevertheless takes the view that the practical effect of Article 9 must be to impose such a restraint. … **The Committee generally agreed that, in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit** …

[Emphasis added]

Accordingly, even if (which we do not accept) the interest rate cap were a thin capitalisation rule, it would still be required to be consistent with the arm's length principle in Article 9.

3.18 Second, and more recently, the OECD TP Guidelines make clear that adopting for transfer pricing purposes a non-elective safe harbour (ie, a cap) that is set below an arm's length rate without providing a mechanism for alleviating relief from the double taxation that could result would be inconsistent with double tax relief provisions of DTAs (OECD TP Guidelines at [4.115]):

Where safe harbours are adopted unilaterally, care should be taken in setting safe harbour parameters to avoid double taxation, and the country adopting the safe harbour should generally be prepared to consider modification of the safe-harbour outcome in individual cases under mutual agreement procedures to mitigate the risk of double taxation. At a minimum, in order to ensure that taxpayers make decisions on a fully informed basis, the country offering the safe harbour would need to make it explicit in advance whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbour. **Obviously, if a safe harbour is not elective and if the country in question refuses to consider double tax relief, the risk of double taxation arising from the safe harbour would be unacceptably high and inconsistent with double tax relief provisions of treaties.**

[Emphasis added]

3.19 This passage is directly relevant here, and is difficult to reconcile with the Discussion Document's assertion that the interest rate cap would not breach New Zealand's DTAs.

3.20 For completeness, there is nothing in the OECD BEPS Action 4 Final Report ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments") or in the OECD BEPS Actions 8-10 Final Reports ("Aligning Transfer Pricing Outcomes with Value Creation") which alters the position set out in the passages above, or indicates that the arm's length pricing rules under the OECD TP Guidelines should not continue to apply with respect to interest. Indeed, any suggestion that the OECD transfer pricing rules cannot apply to cross-border funding, or that the OECD BEPS project has in some way

"abandoned" the arm's length principle with respect to cross-border debt, would seem difficult to sustain. As the TP and PE Discussion Document itself explicitly acknowledges, "the new OECD [TP] guidelines have a particular focus on funding" (TP and PE Discussion Document, paragraph 5.30).

3.21 Adopting an interest rate cap that results in double taxation and breaches New Zealand's DTAs would create increased uncertainty and potential for disputes, for both taxpayers and Inland Revenue. This concern could be addressed by adopting the interest rate cap as a safe harbour, as this would provide a mechanism for alleviating double taxation where the interest rate cap gives a result inconsistent with OECD TP Guidelines.

Interest rate cap does not make sense where particular conditions are required for regulatory reasons

3.22 In addition to being inconsistent with New Zealand's DTAs, adopting an interest rate cap that does not take into account the actual terms of the relevant related-party debt would be problematic for entities such as banks or insurance companies, that have regulatory capital requirements that are satisfied by issuing debt on certain terms prescribed by the regulations. For example, New Zealand registered banks are required to raise capital meeting certain requirements with respect to their terms such as tenor (which may be required to be perpetual), subordination and convertibility or write-off. These features may be critical to the debt qualifying as regulatory capital, and so it would be anomalous and punitive for the interest rate cap to effectively disregard these features in pricing the debt for tax purposes.

3.23 If the interest rate cap were instead adopted as a safe harbour, this concern would not arise, as regulated entities would be able to elect not to apply the safe harbour, and could instead show that a higher rate should be allowed.

Interest rate cap could result in related-party debt being priced lower than third party debt

3.24 The proposed interest rate cap does not permit regard to be had to the particular terms of the related-party debt, including the fact that the debt may be subordinated, or may have a tenor exceeding five years. Given that New Zealand corporates do in fact issue debt on such terms to third parties, this could have the perverse result that a borrower could issue debt to third parties at a higher rate than to its parent.

3.25 We provide examples of third party debt that is subordinated, and/or has a term exceeding five years, below.

<u>Subordination</u>

3.26 As noted above, the proposed interest rate cap requires loans to be priced based on the credit rating for senior unsecured debt, without adjustment for the fact the related-party debt may be subordinated.

3.27 However, New Zealand corporates do issue subordinated debt to third parties. For example, Genesis Energy Limited has both subordinated and unsubordinated bonds on issue that are listed on the NZDX, being:

(a) subordinated capital bonds having a maturity date in 2041, and paying a coupon of 6.190% (NZDX code: GPLFA); and

(b) unsubordinated bonds having a maturity date in 2022, and paying a coupon of 4.14% (NZDX code: GNE030).

3.28 For the interest rate cap to disregard (in pricing related-party debt) the fact that debt is subordinated, in circumstances where corporates do in fact issue subordinated debt to third parties (as illustrated above), would be inconsistent with OECD transfer pricing principles and have the perverse result that New Zealand corporates could issue subordinated debt to third parties at a higher interest rate than to a related party.

Tenor exceeding five years

3.29 The Discussion Document proposes that a related-party loan with a term of longer than five years will be treated as having a term of five years for the purpose of determining the appropriate interest rate under the interest rate cap. This is based on the incorrect assertion that "it is unusual for a commercial loan to be committed for longer than five years" (at paragraph 3.53). In fact:

(a) in addition to the Genesis example given above, there are currently over 40 instruments[2] listed on the NZDX that have maturity dates after April 2022 (and therefore were issued with a term of more than 5 years) or are perpetual. These are set out in the Appendix to this submission;

(b) as noted above, for regulatory reasons it may be necessary to issue debt having a tenor exceeding five years. For example, in order for debt issued by New Zealand registered banks to qualify as Additional Tier One capital, it must be perpetual;

(c) we understand that in practice, a senior lender may require that any debt issued by a borrower have a tenor at least as long as that of the senior debt (so that the related party debt cannot be repaid before the senior debt).

3.30 These issues would not arise if the interest rate cap were adopted as a safe harbour, because (where appropriate) a taxpayer would be able to price related-party debt taking into account the above features.

Grandparenting provisions should apply if interest rate cap adopted other than as safe harbour

3.31 The Discussion Document indicates that existing related-party cross-border debt will be subject to the interest rate cap, with the relevant rate required to be determined based on historic interest rate data for the day on which the interest rate was struck (see paragraphs 3.54 and 3.55).

3.32 We submit, however, that grandparenting rules should be included so that the proposed cap does not apply to arrangements entered into prior to enactment of the relevant amending legislation. There are two reasons for this:

(a) Interest rate cap will apply to non-wholly owned groups: First, the definition of related-party debt to which the interest rate cap would

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2 Note that certain of the instruments listed on the NZDX and included in this figure are preference shares. In addition, while we have not analysed the terms of each of the instruments listed, certain of them could be expected to include rights of repayment, or interest rate resets, prior to their stated maturity date.

apply is broad. It includes arrangements where the borrower and lender are not commonly owned, such as where the lender is a member of a non-resident owning body, or where a limited partner lends to a partnership in which it has a 25% partnership share. It cannot be assumed that the borrower and lender will be in a position to easily renegotiate the terms of that loan at a lower interest rate. Where the interest rate cannot be renegotiated, this would likely result in double taxation (in that a portion of the interest would be non-deductible to the borrower, but assessable to the lender).

(b) Restrictions in lender's jurisdiction may prevent renegotiation of existing debt: Second, even in the case of debt lent within a wholly-owned group, issues could arise in the jurisdiction in which the lender is taxed if the borrower and lender renegotiate the terms of existing debt without payment of a break fee, due to the need for the lender (under the transfer pricing rules of the lender jurisdiction) to act at arm's length from the borrower.

For example, suppose a wholly-owned New Zealand subsidiary had entered into a loan agreement under which it agreed to pay to its Australian parent for a ten year term an interest rate of BKBM plus a fixed margin (say, 4%). Suppose that this margin had been determined in accordance with OECD transfer pricing principles, but that under the proposed interest rate cap, the margin would be just 2%. The Australian Tax Office might argue that a third party lender acting at arm's length arguably would not agree to a reduction in the margin without receiving a break fee from the borrower. It might therefore seek to increase the lender's income by an amount equal to such break fee, or simply ignore the reduction in interest rate. In either case, double taxation would arise.

3.33 These issues would not arise (and grandparenting provisions would not be required) if the interest rate cap were adopted as a safe harbour, because the interest rate cap would be elective for the taxpayer.

Second submission: if the interest rate cap is adopted as a safe harbour, it should be buttressed by other measures to increase certainty and reduce compliance costs

3.34 If the interest rate cap is adopted as a safe harbour, this has the potential to reduce uncertainty and compliance costs for taxpayers and Inland Revenue. However, some uncertainty and compliance costs will remain.

3.35 That is because, in order to apply the interest rate cap, it will be necessary to both:

(a) determine the credit rating of the ultimate parent for senior unsecured debt (or the credit rating the ultimate parent would have, if it issued debt; or the credit rating the New Zealand group would have if there was no ultimate parent); and

(b) determine, for the tenor of the related-party debt, the arm's length price corresponding to the credit rating identified at paragraph (a) above.

3.36 There is potential for uncertainty at both stages of the inquiry: first, when determining a credit rating (where the ultimate parent does not have one, or

there is no ultimate parent), and second in determining the interest rate corresponding to that credit rating.

3.37 With respect to this second step, the Discussion Document indicates that regard should be had to the yield derived from "appropriate" senior unsecured corporate bonds, and explains that (at paragraph 3.23, footnote 11):

> … the margin on bonds at the same credit rating can vary across industries. A taxpayer should be able to demonstrate that their choice of comparator bonds is appropriate.

3.38 In the New Zealand debt market, there will often be no comparable that perfectly matches a given loan's credit rating, tenor and industry. It will therefore often be necessary to either use a less-close domestic comparable, or use an international comparable (eg, US bonds) and undertake a currency conversion. In either case, uncertainty and disputes can arise as to the appropriate comparable to use, and the appropriate adjustments to make. Indeed, it may be that there is more than one correct interest rate, depending on what comparables and methodology the taxpayer (or Inland Revenue) chooses to adopt.[3]

3.39 Accordingly, we submit that:

(a) the existing safe harbour credit margin published by Inland Revenue (being, currently, 250 basis points over the relevant base indicator, where a group of companies has cross-border related-party debt totalling less than $10m principal in the relevant year) should be retained.[4] This means that for very low value loans, it will not be necessary to undertake the detailed analysis described at paragraphs 3.35 to 3.38 above); and

(b) for loans having a principal value below a certain monetary threshold (eg, $50m), Inland Revenue should publish (and periodically update) tables setting out safe harbour guidance as to the credit spread that corresponds to each possible credit rating and tenor. This would alleviate the uncertainty and compliance costs that would otherwise arise when applying the second step in the analysis under the interest rate cap (described at paragraph 3.35(b) above), and therefore provide further incentive for taxpayers to adopt the interest rate cap.

4. TREATMENT OF NON-DEBT LIABILITIES (CHAPTER FOUR)

General comment

4.1 As a general comment, we note that the proposed adjustment for non-debt liabilities will effectively result in a reduction in the permitted debt-to-assets percentage for taxpayers. In other words, the proposed change is not merely a minor clarification to the way in which assets and liabilities are calculated (which could be beneficial for some taxpayers and not for others), but will in all

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3 It is for this reason that, currently, Inland Revenue bears the burden of proving that their method is more "reliable" than the taxpayer's in transfer pricing cases (section GC 13(4)). But this protection will not, as we understand it, apply with respect to the interest rate cap, and is proposed to be removed in transfer pricing cases generally.

4 See http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html.

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cases where it applies result in an increased debt-to-assets ratio for the taxpayer.

4.2 The proposal is therefore one which will (in combination with the other proposals included in the BEPS discussion documents released in March 2017, and other amendments to international tax rules in recent years) further increase the tax burden imposed on foreign investment into New Zealand. Officials should take this into account in any analysis undertaken to determine the overall impact of proposed reforms on the cost of foreign investment in New Zealand, and should consider whether other taxpayer favourable changes (for example, permitting off-balance-sheet assets to be included in assets for thin capitalisation purposes) would also be appropriate.

First submission: taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities

Overview

4.3 The Discussion Document indicates (at paragraph 4.5) that out-of-the-money derivatives are an example of a non-debt liability that does not count as debt for thin capitalisation purposes, and so should be subtracted from assets in performing the thin capitalisation calculation.

4.4 This would exacerbate an existing issue that arises under the thin capitalisation rules, namely that fluctuations in the fair value of a financial arrangement (where the taxpayer applies the fair value method under IFRS) can lead to changes in the debt-to-assets ratio for thin capitalisation purposes from year to year. Accordingly, we submit that taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities

Example

4.5 We set out below an example of the volatility that could be created by the proposal to treat an out-of-the-money derivative valued at fair value (in this case, an interest rate swap) as a "non-debt liability".

4.6 Suppose on day one a taxpayer has assets of $170m, has borrowed $100m at a floating interest rate that is hedged under a fixed-floating interest rate swap, and $70m of equity. Suppose interest rates change, and the swap becomes out-of-the-money and so is recorded as a liability in the taxpayer's accounts (say, a liability of $30m). The taxpayer's balance sheet following the change in interest rates would therefore be as follows:

Assets		**Liabilities and equity**	
Assets	$170m	Loan	$100m
		Interest rate swap	$30m
		Equity	$40m

4.7 Under current law, the taxpayer's debt-to-assets ratio would remain, as on day one, 100/170 = 0.58 (ie, no breach of the thin capitalisation threshold). However, under the proposed change, its debt-to-assets ratio would have risen to 100/140 = 0.71 (ie, a breach of the thin capitalisation threshold).

4.8 Changes in the market value of the swap could therefore result in the taxpayer breaching the thin capitalisation threshold in a particular year. Notably,

however, if interest rates changed again (and the interest rate swap became an asset the following year), there is no "wash-up" mechanism for the taxpayer to reclaim the previously denied interest deductions in the following year.

Proposed solution

4.9 We submit that taxpayers should be entitled to elect that certain classes of derivatives be excluded in calculating assets and liabilities. This would enable taxpayers to ensure that fluctuations in fair value (for those taxpayers applying fair value to an asset or liability under IFRS) do not lead to fluctuations from year to year in debt-to-asset ratios due solely to changes in the fair value of an asset or liability.

4.10 The exclusion should be:

(a) at the election of the taxpayer. That is because making the election could lead to increased compliance costs for the particular taxpayer, and may not be appropriate for all taxpayers in all cases;

(b) on a class basis. That is, the taxpayer should be required to make the election with respect to a class of derivatives. For example, a taxpayer might elect that the exclusion:

(i) applies to interest rate swaps (see the above example); but

(ii) does not apply to cross-currency swaps (on the basis that unlike interest rate swaps, fair value movements in the currency swap may match changes in the NZD value of a foreign currency loan, and so in fact act to prevent rather than increase fluctuations in debt-to-asset ratios caused by currency movements).

4.11 The requirement that elections are made on a class basis rather than in respect of particular financial arrangements will prevent taxpayers "picking and choosing" which particular financial arrangements the exclusion applies to based on whether that financial arrangement is likely to be an asset or liability. Restrictions on the ability to change the election between income years could also be included.

Second submission: RPS and deferred tax liabilities should be excluded from "non-debt liabilities"

4.12 The Discussion Document proposes to subtract interest-free shareholder loans from "non-debt liabilities" (at paragraph 4.22). We support the exclusion of interest-free shareholder loans, and submit that, in addition, the following should also be excluded from the definition of "non-debt liabilities":

(a) RPS;

(b) deferred tax liabilities. That is because deferred tax liabilities do not represent true liabilities in the same way as, for example, amounts owed to trade creditors. Rather, they result from differences between the tax and accounting treatments of amounts.

4.13 In the case of deferred tax liabilities, we submit that, instead, both deferred tax assets and deferred tax liabilities should be excluded from the measurement of

total assets and total debt. This would align with the position in Australia (see the Income Tax Assessment Act 1997 at section 820-682).

5. OTHER MATTERS (CHAPTER FIVE)

5.1 The net current valuation method should not be removed from the list of available asset valuation methods. If officials are concerned that net current values adopted under this method are inaccurate, rather than removing the method, a requirement to obtain an independent valuation when applying the method could be introduced.

Yours faithfully
RUSSELL McVEAGH

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APPENDIX

NZDX LISTED INSTRUMENTS WITH MATURITY DATE POST-APRIL 2022[5]
(See paragraph 3.29(a) of submission)

Company	NZDX code	Freq.	Coupon (%)	Maturity
ANZBANKNZ	ANBHA	2	5.28	Perpetual
ANZBANKNZ	ANBHB	4	7.2	Perpetual
CAS	CASHA	4	5.04	Perpetual
FONTERRA	FCGHA	4	4.38	Perpetual
INFRATIL	IFTHA	4	3.63	Perpetual
Kiwi Funding	KCFHA	4	7.25	Perpetual
MOTORFINANCE	MTFHC	4	4.47	Perpetual
NUFARM	NFFHA	2	5.89	Perpetual
QUAYSIDE	QHLHA	4	4.32	Perpetual
RABOBANK	RBOHA	4	2.88	Perpetual
RABOCAPITAL	RCSHA	4	8.34	Perpetual
WORKSFINANCE	WKSHA	4	6.29	Perpetual
IAG	IAGFB	4	5.15	15/06/2043
GPL	GPLFA	4	6.19	15/07/2041
LGFA	LGF080	2	3.5	14/04/2033
LGFA	LGF060	2	4.5	15/04/2027
SparkFinance	SPF570	4	3.94	7/09/2026
AUCKCITY	AKC100	2	3.34	27/07/2026
WGTNAIR	WIA050	2	5	16/06/2025
LGFA	LGF070	2	2.75	15/04/2025
WGTNAIR	WIA040	2	4	5/08/2024
NZXR	IFT230	4	5.5	15/06/2024
AUCKCITY	AKC070	2	5.81	25/03/2024
MERIDIAN	MEL040	2	4.88	20/03/2024
AUCKAIR	AIA210	2	3.97	2/11/2023
Z ENERGY	ZEL050	4	4.32	1/11/2023
INFRATIL	IFT210	4	5.25	15/09/2023
KiwiProperty	KPG020	2	4	7/09/2023
ANZBANKNZ	ANB130	2	3.71	1/09/2023
BNZBANK	BNZ110	2	4.1	15/06/2023

5 Source: http://www.anzsecurities.co.nz/directtrade/dynamic/fixedinterest.aspx, accessed 11 April 2017.

WGTNAIR	WIA030	2	4.25	12/05/2023
NZGOVERN	GOV410	2	5.5	15/04/2023
LGFA	LGF050	2	5.5	15/04/2023
MERIDIAN	MEL030	2	4.53	14/03/2023
SparkFinance	SPF560	4	4.51	10/03/2023
FONTERRA	FCG040	2	4.42	7/03/2023
TRUSTPOWER	TPW150	4	4.01	15/12/2022
CONTACT	CEN040	4	4.63	15/11/2022
AUCKAIR	AIA200	2	4.28	9/11/2022
AIRNZ	AIR020	2	4.25	28/10/2022
SKYCITY	SKC040	4	4.65	28/09/2022
Transpower	TRP040	2	4.07	16/09/2022
Transpower	TRP030	2	4.3	30/06/2022
GMT BOND	GMB030	2	5	23/06/2022
INFRATIL	IFT190	4	6.85	15/06/2022

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27 April 2017

Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON

Dear Cath

BEPS – Strengthening our interest limitation rules

Deloitte ("We" or "Our") is writing to submit on Chapter 3 of the Government Discussion Document of March 2017 – "BEPS – Strengthening our interest limitation rules" (the Discussion Document). For all other aspects of the Discussion Document, we support the submissions made by the Corporate Taxpayers Group.

We appreciate the opportunity to submit on this Discussion Document and would be happy to meet with Officials to discuss any of the matters raised in this submission further.

Summary

We submit that:

The problem of excessive interest rates identified by the Discussion Document should be addressed through the application of transfer pricing rules and the arms-length principle. Proposed changes to transfer pricing rules and guidelines that New Zealand has separately proposed to adopt, should themselves resolve the problem of excessive interest rates.

The proposed approach, capping allowable interest based on a five year term and on the interest rate that would apply to an associate parent entity when raising senior unsecured short term debt, is inconsistent with the OECD's recommended approach, the rest of the world (ROW) approach (including Australia) and with commercial practice. It also seems to be inconsistent with double taxation agreements. A poorly targeted thin capitalisation regime that is out of step with the ROW will undermine New Zealand's ability to attract capital for higher risk and longer term investments. It also creates the potential for double taxation.

A parent company's credit rating is relevant to related debt in only very limited circumstances, where the parent guarantees lending arrangements. It should not be arbitrarily applied to all related party debt without regard to the ability of the parent company to control the subsidiary and to provide credit support to the subsidiary.

In any event, any changes made should be subject to grandparenting, due the long term nature of existing investments which have been made in reliance on the existing thin capitalisation rules and which cannot be easily unwound. The regime should not penalise compliant taxpayers within the 60% thin capitalisation threshold. In our view, the appropriate treatment would be for arrangements entered into prior to the date of enactment to be excluded from any new rules.

Interest rates should be governed by transfer pricing and the arms-length principle

An interest rate cap is proposed to limit allowable interest deductions on non-commercial loans. We submit that changes to transfer pricing rules and guidelines that New Zealand has separately proposed to adopt (including those in the Inland Revenue's transfer pricing discussion document: *BEPS – Transfer Pricing and Permanent Establishment Avoidance*), should themselves resolve any problem of excessive interest rates On non-commercial loans. Under the new proposals, transfer pricing will require consideration of the interest rates, quantum of debt and the terms of the debt. In other words, price (interest rate), quantum (level of gearing) and the terms of the debt need to be considered from a commercial perspective in an integrated approach. Moreover, transfer pricing will seek to disregard the legal form if it does not align with economic substance.

If the interest rate cap proposal is adopted in its current form, it would itself give rise to a result that is inconsistent with a comparable third party transactions and would price debt on an uncommercial basis.

The proposed approach is inconsistent with the OECD's recommended approach and inconsistent with the rest of the world approach

The Discussion Document approach is different from the OECD's recommended EBITDA approach for limiting interest deductibility.

The proposed approach is also inconsistent with the rest of the world approach. In general the rest of the world has "thin cap rules" to determine the overall level of deductible debt or quantum (i.e. 60% of assets/net assets as the safe harbour which is a variant to the EBITDA approach). It is then up to the "transfer pricing" rules to determine arms-length rate.

As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". We submit there is no rational basis for New Zealand to be out of step with the ROW by not applying the arms-length standard.

Australia applies transfer pricing to limit related party cross border interest rates and in doing so can adjust such rates in accordance with identified uncommercial terms along the lines set out in the Discussion Document - the loan being highly subordinated, repayable on demand, having extremely long terms, convertible into shares.

The Australian thin capitalisation rules, including using an arms-length approach for setting maximum debt levels, were recently subject to a comprehensive review by the Australian Board of Taxation[1]. This concluded that the arms-length test is the "central plank of the thin capitalisation rules". While further changes in Australia are possible, we expect the approach to be adopted will be for a parent company's credit rating to be just one factor to be considered, where relevant, when determining whether an interest rate is an arms-length rate. A like approach could be adopted in New Zealand by including reference to the interest rate cap and the five year loan term in the proposed guidelines for the purpose of assessing transfer pricing risk in respect of related party loans.

The proposed approach will raise the possibility of international double taxation

The issues identified above will also increase the risk of international double taxation. For example, New Zealand denies an interest deduction to a parent and in effect treats part of the interest as a non-deductible dividend. The parent company is taxed on interest but not dividends. It could also give rise to a taxable interest stream in a foreign subsidiary which follows the arm's length standard but a denial of interest deductions to the NZ parent.

[1] Australian Board of Taxation[1] – Review of the Thin Capitalisation Arms-Length Debt Test December 2014

Adjusting interest deductions within the transfer pricing framework has the very significant advantage of incorporating measures to reduce the risk of double international taxation. If the New Zealand adjustment to interest deductibility is made under transfer pricing rules then under paragraph 2 of Article 9 of the Model convention a collateral adjustment is required by the parent company jurisdiction so as to avoid double taxation. No such adjustment seems possible under the approach proposed in the Discussion Document.

The proposed changes go beyond the problem identified in the Discussion Document

The policy concern that underlies the thin capitalisation rule changes is that debt can be substituted for equity so that what would in the absence of tax be taxed as an equity return (28% plus any NRWT) is instead taxed at the much lower rates on interest.

We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent, there is an increased risk associated with parent lending which may be used to justify a higher interest rate while not altering the parent's overall investment risk. The underlying assumption in the Discussion Document seems to be that a parent would borrow from third parties using its better credit rating and then on-lends the funds to its subsidiary; and the parent has an implicit duty to support its subsidiary.

However, in most circumstances this assumption will not apply, for example:

> Where an offshore entity does not control or hold all of the shares in the New Zealand entity. The thin capitalisation ownership test does not properly target control of subsidiaries and for example under current rules, non-voting preference shares can be attributed control ownership status;
>
> An offshore parent (such as a Unit Trust) that is precluded by regulatory or fiduciary obligations from providing support to the subsidiary entity; or
>
> Institutional investors which will shield themselves from stand-alone investment risk so as to limit risks to the fund's overall exposure, as part of the "enterprise risk management policy".

In these cases the commercial cost of funds of the New Zealand entity will not reflect the cost of funds of any overseas investor in that entity.

We submit that any interest cap based on the parent's cost of borrowing should be limited to situations where any increase in debt risk can reasonably be viewed as not altering the overall risk assumed by any investor so that the increased interest rate can in substance be viewed as a dividend return on equity. This will clearly not be the case for non-controlled entities and where there are legal, regulatory or other prohibitions to providing support to the New Zealand entity.

Further, the Discussion Document proceeds on the basis that a term over 5 years is uncommercial. Limiting the term to 5 years will give rise to pricing which is not consistent with comparable third party transactions noting that debt instruments such as bonds, tend to have terms exceeding five years. Longer term debt instruments are clearly relevant for longer term investments. We submit that the arbitrary five year term should be removed. The term of the loan should be determined by reference to arms-length standards.

The proposed approach will result in interest adjustments beyond the problem identified in the Discussion Document and will make New Zealand less attractive as an investment destination. The economic costs of unduly restricting the deductibility of the interest costs of New Zealand enterprises are, in our view, high.

Grandparenting

We submit that, if any changes are to be made, they should be subject to grandparenting. Significant investment decisions have been made based on existing settings and a lot of these arrangements involve external commitments (not necessarily internal group arrangements) that cannot be easily unwound.

Uncertainty and risk is of course inherent in any investment, particularly for long term investments. However, the impact of the proposals in the discussion document, if enacted in their current form, would materially affect the post-tax return on significant investments. This would also undermine the confidence of offshore capital market participants in determining whether to invest (or continue to invest) in New Zealand projects in the future.

As a result, we submit that the proposals, if enacted, should include grandparenting. In our view, the appropriate treatment would be for arrangements entered into prior to the date of enactment to be excluded from any new rules.

Concluding remarks

We have strong reservations about the proposed changes to New Zealand's thin capitalisation regime and in particular on the departure from the arms-length basis which is the global transfer pricing standard.

For any queries in relation to this submission, please contact Teresa Farac (09 303 0845).

Yours sincerely

Teresa Farac
Partner
for Deloitte Limited *(as trustee for the Deloitte Trading Trust)*

28 April 2017

c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
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Wellington 6140

Policy.webmaster@ird.govt.nz

Dear Deputy Commissioner,

Submission on the discussion document "Strengthening our interest limitation rules"

Thank you for the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on the *BEPS – Strengthening our interest limitation rules Government discussion document* (the **Discussion Document**). We also appreciate discussion held to date with Officials in respect of the Discussion Document.

ANZ Bank New Zealand Limited (**ANZ**) recognises and supports the Government and IRD Official's work to combat base erosion and profit shifting out of New Zealand using excessively priced related party debt. ANZ considers that any such rules must appropriately balance combatting aggressive behaviour but not extend so far as to limit genuine commercial behaviour. If such a balance is not appropriately struck, the New Zealand economy will suffer through inefficient importation of capital, particularly compared to New Zealand's competitors of imported capital.

The reality of this balance for New Zealand is highlighted at paragraph 1.4 of the Discussion Document:

> *"While the majority of firms subject to the thin capitalisation rules have taken conservative debt positions, there is a minority that engages in more aggressive tax practices. Of particular concern is that some firms have borrowed from their foreign parent at high interest rates, resulting in very large interest deductions in New Zealand. A proposal to address this is discuss in chapter 3.*

It is chapter 3 of the Discussion Document that is the focus of ANZ's submission.

In summary, ANZ considers that the proposals in chapter 3 do not strike the appropriate balance referred to above. While the proposals may appropriately combat the minority of aggressive taxpayers, the blanket approach of the proposals will also penalise taxpayers that apply commercial terms and rates to cross border related party debt, in particular the banking industry where such debt, due to regulatory necessity, is priced above a senior unsecured rate. Such an imbalance has the very real effect of placing inefficiencies on importing capital.

Summary of key submission points

Our submissions, summarised below, focus on the impact of the proposed interest rate limitation on New Zealand registered banks. We provide further context to our submissions in Appendix 1.

1. The proposed interest rate limitation should not apply to New Zealand banking groups:

    - New Zealand banking groups are subject to significant prudential regulation that limits the level of, and requires arm's length pricing for, cross border related party funding. As such New Zealand banking groups do not present the risk that the proposed rules are seeking to target.
    - Bank regulatory capital, as a significant portion of funding from offshore parents, would become inefficient to raise if the proposals applied to New Zealand banking groups, resulting in tax outcomes that do not reflect commercial and regulatory positions, a disadvantage for New Zealand banking groups compared to other industries and double taxation.
    - Excluding New Zealand banking groups from the proposals would not be contrary to the position adopted by the OECD for the banking industry.

2. If our above submission is not accepted, we consider that the interest limitation proposals should apply as a safe harbour only and not over ride application of the transfer pricing rules.

3. If, contrary to the above submissions, the interest limitation proposals proceed, we submit that the limitation should not apply to related party debt arrangements in existence at the date of enactment of the amending legislation.

4. ANZ submits that funding from offshore branches of New Zealand banking group entities are not caught within the proposed rules.

5. ANZ submits that ongoing consultation of the interest limitation proposals continue before a Bill is introduced into Parliament.

About ANZ

ANZ is the largest financial institution in New Zealand and is a regulated bank subject to prudential supervision by the Reserve Bank of New Zealand (**RBNZ**). The ANZ group comprises brands such as ANZ, UDC Finance, ANZ New Zealand Investments, ANZ New Zealand Securities and Bonus Bonds.

ANZ offers a full range of financial products and services including a significant range of financial advisory services, personal banking, institutional banking and wealth management services.

Publication of submission

ANZ requests that this submission on the Discussion Document is kept confidential by the IRD on the grounds of commercial sensitivity.

Contact for submission

ANZ welcomes the opportunity to discuss any of our submissions directly with IRD officials. Please contact me on [redacted] if you would like to discuss our submission further.

Once again, we thank IRD for the opportunity to have input into the proposals on the proposals to strengthen New Zealand's interest limitation rules and look forward to ongoing consultation on this issue.

Yours sincerely

PhLeath

Philip Leath
GM Tax, New Zealand
ANZ Bank New Zealand Limited

APPENDIX 1 - Submission points

1. The proposed interest rate limitation should not apply to New Zealand banking groups:

- **New Zealand banking groups are subject to significant prudential regulation that limits the level of, and requires arm's length pricing for, cross border related party funding. As such New Zealand banking groups do not present the risk that the proposed rules are seeking to target.**
- **Bank regulatory capital, as a significant portion of funding from offshore parents, would become inefficient to raise if the proposals applied to New Zealand banking groups, resulting in tax outcomes that do not reflect commercial and regulatory positions, a disadvantage for New Zealand banking groups compared to other industries and double taxation.**
- **Excluding New Zealand registered banks from the proposals would not be contrary to the position adopted by the OECD for the banking industry.**

1.1 ANZ considers the core premise behind the interest limitation proposals is that an offshore parent's average cost of funding is an appropriate approximation of the cost of funding for its New Zealand subsidiary, at least in respect of cross border related party funding. Relevantly, paragraphs 3.24 and 3.25 of the Discussion Document state:

> *"We consider that the interest rate that a multinational could obtain when raising senior unsecured debt (either determined with reference to its credit rating, or calculated based on other factors) is a reasonable approximation of the multinational's cost of funds."*
>
> *"This proposed rule would therefore anchor the deductible interest rate on intra-group debt to a multinational's actual cost of debt. We consider this reasonable. For example, one funding option available to a multinational would be to raise third-party debt and on-lend the debt to its New Zealand subsidiary.* ***We consider it unlikely that the multinational would have its New Zealand subsidiary borrow from a third party at an interest rate significantly higher than the multinational's cost of debt, since this would lower its overall profits."***

[emphasis added]

Such a premise appears to assume that the majority of funding for the New Zealand subsidiary is obtained from its offshore parent, the New Zealand subsidiary would only source, in an economic sense, senior unsecured debt and that there is a choice as to the form or legal terms of related-party debt issued to an offshore parent. This may well be the case for some foreign owned New Zealand corporates. Such a premise, however, is not the case for the ANZ New Zealand banking group.

ANZ's Source of funding

1.2 ANZ predominantly obtains its funding from 3 sources:

- capital (comprising ordinary equity and retained earnings (collectively common equity tier 1 capital) and other bank regulatory capital);
- domestic deposits; and
- offshore and onshore wholesale funding.

1.3 From an ANZ New Zealand geographic perspective, the level of debt funding from the ultimate offshore parent (including offshore subsidiaries) is ~2.4% of its total debt funding[1].

Regulation on funding sources

1.4 ANZ's source of funding is subject to significant prudential regulation. ANZ faces regulation from both the Australian Prudential Regulation Authority (**APRA**) and the RBNZ in respect of the limits and pricing of related party debt.

1.5 APRA's prudential standard APS 222 (Associations with Related Entities)[2] limits an Australian Authorised Deposit Taking Institutions' (**ADIs**) exposure to related ADIs (including overseas based equivalents) to 50% of the amount of the Australian ADI's Level 1 regulatory capital. APRA has imposed further limits on an Australian ADI's exposures to certain New Zealand foreign owned banks which require that, by 1 January 2021, no more than 5% of the Australian ADI's Level 1 Tier 1 Capital comprise non-equity exposures to its New Zealand operations (excluding regulatory capital instruments, which we address further below). As a result, the ANZ New Zealand group (including the New Zealand holding company) can only obtain a minority of its funding from its offshore parent.

1.6 The RBNZ impose various regulations that directly and indirectly impact the source of funding for New Zealand banks. New Zealand registered banks are required to maintain core funding ratios (refer RBNZ Document BS13 – Liquidity Policy)[3]. Broadly, core funding ratios (**CFR**) require banks to have diversity over sources of funding to manage appropriate liquidity within the New Zealand financial system. The calculation of CFR includes a preference for funding from deposits over wholesale funding (which, for CFR purposes, includes related party funding). In addition, a condition of registration for ANZ for New Zealand banking prudential purposes is that *"the bank's constitution must not contain any provision permitting a director, when exercising powers or performing duties as a director, to act other than in what he or she believes is in the best interests of the company (i.e. the bank)"*. This requirement logically requires ANZ to act on arm's length with its offshore parent and cannot deliberately source uncommercial or excessively priced related party debt, for doing so would not be in the best interests of ANZ.

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[1] From 30 September 2016 Australia and New Zealand Banking Group Limited – ANZ New Zealand Registered Bank Disclosure Statement (excludes debt allocated from ultimate parent to NZ Branch of ultimate parent, which must be reduced to ensure compliance with APRA's APS 222 standard by 1 January 2021).

[2] Australian Prudential Standard APS 222: Associations with related entities, January 2015, available at: http://www.apra.gov.au/CrossIndustry/Documents/141120-APS-222.pdf

[3] RBNZ Document BS13 regarding reporting of liquidity policy, including core funding ratios, available at http://www.rbnz.govt.nz/regulation-and-supervision/banks/prudential-requirements/liquidity-policy

1.7 ANZ considers that such prudential regulation strongly mitigates the risk that the proposals seek to counter.

Bank regulatory capital

1.8 A primary source of ANZ's debt funding from its offshore parent bank is regulatory capital. Regulatory capital contains unique features which are required by prudential regulators (often both RBNZ and APRA). The RBNZ framework for bank regulatory capital as set by the Basel Committee (referred to as the Basel III framework) requires banks to hold 10.5% bank regulatory capital over risk weighted exposures, at least 7.0% of which must comprise Common Equity Tier 1 (**CET1**) Capital (i.e. ordinary shares and retained earnings).

1.9 A bank's regulatory capital can also comprise Additional Tier 1 (**AT1**) and Tier 2 (**T2**) capital, provided such capital complies with the prudential regulations. These regulatory requirements include subordination, permanence, flexibility of payment and loss absorbency measures. These are mandatory requirements. From a cost of capital perspective, CET1 is the most expensive, followed by AT1 and then T2. As such, ANZ holds a mix of such bank regulatory capital for economic cost of capital reasons. ANZ has issued AT1 instruments ranging in tenor from 5 to 10 years before any redemption can be made, subject to RBNZ (and where relevant APRA) approval. As a consequence of the mandatory regulatory features, AT1 and T2 instruments are priced above senior unsecured debt.

1.10 While ANZ has issued regulatory capital instruments to the New Zealand market, the New Zealand market is not sufficiently deep or liquid to absorb the regulatory capital needs of all New Zealand banks (including ANZ). Consequently, it is necessary that regulatory capital funding is obtained from international markets. It is often preferable for ANZ to access offshore markets for regulatory capital through its foreign parent rather than doing so directly for the following reasons:

i. ANZ would not issue direct into the Australian market as doing so places ANZ in direct competition with its parent (who also regularly accesses the Australian market for its regulatory capital requirements).

ii. Bank regulatory capital issued directly by ANZ into the market will not count as Level 1 capital for our ultimate Australian parent (Level 1 capital is preferable). Further, our parent bank incurs a haircut or reduction in the amount of regulatory capital it can recognise for any regulatory capital externally issued by ANZ.

iii. If our parent issues regulatory capital externally and provides regulatory capital to ANZ, only one set of regulatory rules applies to each capital instrument (i.e. APRA for the parent issued instrument and RBNZ for the ANZ issued instrument). By comparison, if ANZ issues regulatory capital externally both APRA and RBNZ rules apply to that single instrument creating significant complexity and cost in applying 2 sets of regulatory rules which are not perfectly aligned.

iv. It is more economic for ANZ's foreign parent to raise regulatory capital in the international markets and then provide that regulatory capital to ANZ than it is for ANZ to issue regulatory capital direct into international markets. For completeness and as noted above, the Board of the New Zealand registered bank would only issue bank regulatory capital to its parent an arm's length to ensure the Board is acting in the best interest of the New Zealand registered bank.

1.11 At this point, it is worth noting that ANZ is owned 100% by a New Zealand holding company which, in turn, is ultimately 100% owned by our Australian parent ADI. Where ANZ's foreign parent provides regulatory capital to ANZ, this could occur by providing non-regulatory debt funding to the New Zealand holding company which then provides the regulatory capital funding to ANZ. The debt funding to the New Zealand holding company cannot be regulatory capital as the New Zealand holding company is not a registered bank. However, such debt should closely mirror the terms, and therefore pricing, of the regulatory capital issuances. If this was not the case (for example if the debt from the offshore parent to the New Zealand holding company was senior unsecured debt) the New Zealand Holding company could be left in a position that if interest is not paid on the regulatory capital it holds in ANZ (as noted above, interest on regulatory capital is subject to flexibility of payment and must be non-cumulative) it would still have interest payable on the debt it has issued to the offshore parent. This would present a non-commercial outcome and present risks of insolvency for the Board of the New Zealand holding company. Equally the offshore parent holding the debt in the New Zealand holding company would end up in a position of having borrowed at a higher interest rate but having on-lent at a lower interest rate, creating an uneconomic and uncommercial outcome, again presenting issues for the Board of the offshore parent company. The use of a New Zealand holding company, as above, should result in a similar position, economically and tax wise, as if our Australian parent ADI provided regulatory capital direct into ANZ (and not through the New Zealand holding company). Further, we note that the foreign parent's holding of debt in the New Zealand holding company remains subject to APS 222.

1.12 Due to the unique requirements of bank regulatory capital and the reliance on offshore parent banks to provide such bank regulatory capital for the New Zealand banking system, ANZ submits that New Zealand banking groups should be excluded from the proposals in the Discussion Document. If New Zealand banking groups are not excluded from the proposals, an absurd tax policy outcome will arise in that, on a post-tax basis, it will become more economic for New Zealand banks to raise capital direct from international markets at higher interest rates than to obtain bank regulatory capital from our offshore parents at lower interest rates. The proposals would create a tax divergence from true economic positions resulting in inefficient capital raising for New Zealand banks.

1.13 It is not possible to restructure bank regulatory capital to have terms that are commensurate to senior unsecured debt. The terms of bank regulatory capital are mandatory and it is these mandatory requirements that result in such debt carrying a commercial but higher interest rate than that for senior unsecured debt. The proposals would, therefore, place New Zealand banks at a disadvantage (at least in a tax sense) to other New Zealand taxpayers that can change the terms of cross border related party debt.

1.14 Further, the proposals will result in double taxation on bank regulatory capital obtained from our parent. As above, bank regulatory capital carries an interest rate higher than our parent's senior unsecured rate. Therefore, a denial of a full deduction on the interest rate (i.e. actual interest paid) would arise in New Zealand. However, Australia (in ANZ's case) would not be bound by New Zealand's interest rate limitation and would require an arm's length price based on appropriate commercial terms reflecting the interest rate for bank regulatory capital for the tenor of the capital issued. It would not be possible to simply reduce the amount of interest paid on such instruments for regulatory reasons. In this regard, the proposed interest limitation rules appear to apply unilaterally from New Zealand's double tax treaty network such that it would not be possible to invoke the relevant Tax Treaty competent authority procedures.

1.15 Referring back to paragraphs 3.24 and 3.25 of the Discussion Document, the senior unsecured debt rate reflecting our parent's credit rating does not approximate the commercial requirement to access regulatory capital from our parent and the unique mandatory regulatory requirements of such capital which result in a commercial interest rate above a senior unsecured rate. This unique position in the banking industry was noted by the OECD in a public discussion draft on Action 4 that the "excessive leverage in a bank or insurance company has not been identified as a key risk"[4]. As such, ANZ considers that excluding New Zealand banking groups from the interest limitation proposals is not contrary to OECD guidance.

2. If our above submission is not accepted, we consider that the interest limitation proposals should apply as a safe harbour and not override application of the transfer pricing rules.

2.1 We understand from officials that the proposed interest limitation is a formulaic approach to interest limitation to reduce the time and effort required for taxpayers and the IRD to mutually agree on an arm's length price under the transfer pricing (**TP**) rules and, accordingly, may increase certainty for taxpayers. Assuming this will be the outcome, this should not come at the expense of accuracy, especially by imposing real tax costs on compliant industries and, as above, for industries that have regulatory requirements that would result in the broad formulaic approach diverging from accuracy and commercial reality. The proposal would inappropriately override commercial positions, being an interest rate that, under TP pricing rules would be considered arm's length.

2.2 Alongside the Discussion Document, officials have also proposed changes to strengthen the TP rules. The proposed changes in the Government Discussion Document on *BEPS – Transfer pricing and permanent establishment avoidance*, provide broad powers for the IRD to consider a company's debt raising and to restate the quality of debt instruments to reflect the economic substance. On application of the proposed TP rules, transactions with excessively priced debt that are artificial and based on uncommercial terms would be ineffective. The interest rate would then be revised to reflect economic reality. There is

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[4] OECD, *BEPS Action 4: Approaches to address BEPS involving interest in the banking and insurance sectors*, p.10, available at: https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf

significant overlap between what the TP changes and the interest rate cap are intended to achieve. In our view, the core principle is, and must continue to be, that interest rates be set on an arm's length basis. It is critical that taxpayers retain the ability to establish, through the TP rules and subject to the IRD's review, an interest rate on cross-border debt that is based on appropriate commercial terms. The proposed interest limitation should not override genuine analysis of arm's length terms and conditions.

2.3 ANZ considers that the interest limitation proposal will not result in a significant easing of compliance. Taxpayers are, in a practical sense, required to ensure cross border prices are arm's length through assessment of their own credit position and considering comparable prices. The interest limitation proposal will still require such an obligation but merely shift the entity of focus from the New Zealand taxpayer to the offshore parent entity. Further, ANZ considers that any comparable pricing should not be limited to secondary markets (i.e. traded bonds). For example, secondary markets do not reflect the reality of costs of issuing new debt, including new issue premiums.

2.4 If the above submission to exclude banks from the scope of the proposed interest rate limitation is not accepted, ANZ submits that the interest rate limitation should act as a 'safe harbour' threshold. It should not override the TP rules or prevent an arm's length price from being established. Debt instruments with interest rates within the limitation threshold should not need to be reviewed against TP principles (i.e. are deemed to be TP compliant). This may still reduce compliance costs for taxpayers and administrative costs for the IRD. For instruments with interest rates greater than the proposed interest limitation (such as bank regulatory capital), taxpayers should continue to have the opportunity to apply the TP rules to establish an arm's length price. If such a position is not accepted for all cross border related party debt, it should apply, at least, to transactions relating to banking regulatory capital for the regulatory reasons outlined above which make bank regulatory capital unique.

3. If, contrary to the above submissions, the interest limitation proposals proceed, we submit that the cap should not apply to related party debt arrangements in existence at the date of enactment of the amending legislation.

3.1 The Discussion Document proposes that the interest rate cap will apply from the first income year beginning after enactment of the legislation (refer paragraph 5.36). Officials consider that this should give companies sufficient time to rearrange their affairs.

3.2 For the New Zealand banking industry, it is highly unlikely to be possible to rearrange such instruments due to their regulatory overlay. Further, in ANZ's context, we regularly seek IRD approval on the pricing of cross border funding. It would be inappropriate to over-ride such existing agreed positions.

3.3 Therefore, if the proposals proceed as drafted, we submit that the interest limitation should not apply to existing funding arrangements which have been reviewed, or are in the process of being reviewed, by the IRD under the TP rules to establish an arm's length price. The proposals should only apply to new arrangements entered into after the date of enactment.

4. ANZ submits that funding from offshore branches of New Zealand bank group entities are not caught within the proposed rules.

4.1 ANZ accesses debt by raising securities and commercial paper in international markets through a foreign branch of a subsidiary of ANZ. The foreign branch on-lends this debt into ANZ. The on-lending into ANZ is subject to TP rules.

4.2 The proposal for "related-party" debt in the Discussion Document at paragraph 3.43, however, may be sufficiently broad that it will include the on-lending from the offshore branch into ANZ within the interest limitation proposals. Such on-lending has no association to our parent's funding costs and therefore, should not fall within the interest limitation proposals.

4.3 ANZ understand from discussions with Officials that it is not intended for such funding from offshore branches to be included within the proposals. ANZ, therefore, submits that if our submission above at paragraph 1 is not accepted, any amending legislation is drafted to ensure such on-lending is not captured.

5. ANZ submits that ongoing consultation of the interest limitation proposals continue before a Bill is introduced into Parliament.

5.1 ANZ recommends and would welcome ongoing consultation on any further development of the interest limitation proposals prior to drafting of legislation. Given the complexity of this topic and its deviation from long standing tax principles, ANZ would also welcome the opportunity to consider any draft legislation of exposure draft prior to introduction to Parliament as a Bill.

#020

Response to

Inland Revenue

on the

Government discussion document:

BEPS – Strengthening our interest limitation rules

28 April 2017

1.0 INTRODUCTION

1.1 This submission has been prepared by Bank of New Zealand ("BNZ") in response to Inland Revenue's ("IR") discussion document, 'BEPS – Strengthening our interest limitation rules', released on 3 March 2017 ("Discussion Document").

1.2 BNZ welcomes this opportunity to provide a response to IR's Discussion Document. While BNZ is wholly supportive of actions to counter aggressive tax planning and tax avoidance, BNZ remains of the view that any legislative reform to counter aggressive tax planning must be appropriate for, and targeted at, the mischief it is intended to address. Many of the proposals contained in the discussion document have broad reach and are, in a number of cases, insufficiently targeted. A consequence of this is that compliant taxpayers who are currently paying a "fair amount of tax" will be affected, and in the case of the proposed interest rate cap, will be potentially exposed to double taxation.

1.3 BNZ is a member of the Corporate Taxpayers Group ("CTG") and the New Zealand Bankers' Association ("NZBA") and has been involved in the submissions each group has made on the discussion document. While BNZ is in total alignment with the submissions made by the CTG and the NZBA, BNZ wishes to make an additional submission on specific aspects of the proposals.

2.0 EXECUTIVE SUMMARY

2.1 The Discussion Document notes that it is a minority of firms that have borrowed from their foreign parents at high interest rates. If the issue is confined to a minority of firms, then a targeted response would be more appropriate. The introduction of the proposed reconstruction provision in the recently released discussion document on Transfer Pricing and Permanent Establishment Avoidance ("TP Discussion Document") should provide IR with sufficient tools to deal with those specific situations where excessive interest deductions are being claimed.

2.2 The proposed interest rate cap would significantly increase the potential for double taxation and does not allow for competent authority resolution when the other jurisdiction requires a higher rate of interest to be charged under its transfer pricing rules, based on the international standard arms-length principle.

2.3 If the interest rate cap proposal does proceed, banking regulatory capital should be excluded. The subordinated nature and longer terms for which regulatory capital debt is issued is a direct consequence of the rules mandated by the Reserve Bank of New Zealand ("RBNZ"), and/or the Australian Prudential Regulatory Authority ("APRA"). Debt that is issued for banking regulatory capital purposes is patently not issued so as to engineer excessive interest deductions and so should not be subject to the proposed interest rate cap. For banking regulatory capital, it is appropriate that the interest rate permitted for tax purposes is based on an arms-length rate of interest as that is what is required by RBNZ.

2.4 If the interest rate cap proposal proceeds, the definition of related party debt should be defined such that debt raised from third parties by a subsidiary of a New Zealand bank and then on-lent to the registered bank is not caught by the interest rate cap.

2.5 If the interest rate cap proposal proceeds, it should only operate as a safe-harbour, such that if a taxpayer chooses to be subject to the interest rate cap, full transfer pricing documentation supporting the arms-length price would not need to be prepared. However, the international standard arms-length principle should be retained for taxpayers who are prepared to carry out a transfer pricing exercise to establish an arms-length interest rate.

2.6 If the proposal proceeds, withholding tax should only apply to the extent that a tax deduction has been claimed. This would result in greater consistency with other recent legislative changes seeking to align the imposition of withholding tax with the deduction of interest costs by the borrower.

3.0 SUBMISSIONS

The proposed interest rate cap disregards the arms-length principle

3.1 BNZ does not support the proposed interest rate cap as it is a significant departure from the arms-length principle and will result in tax outcomes that are inconsistent with the real commercial and economic substance of the underlying arrangements.

3.2 The stated objective of the rule is to ensure pricing of related party debt is roughly in line with the interest rate the borrower would agree with a third party lender. In our view an interest rate cap does not necessarily achieve this. The proposal to base the interest rate on the senior unsecured corporate bonds rate assumes that all debt issued by the group would be senior unsecured debt, whereas there may be good commercial reasons for subordinated debt to be issued. Banking regulatory capital is a case in point.

3.3 The proposed interest rate cap also assumes that the interest rate a subsidiary would be able to agree with a third party financier is only marginally different from what the subsidiary's global parent could agree. This effectively treats a multinational group as a single commercial entity, and in doing so, any fundamental differences that exist between entities within a group, such as the nature of the businesses they conduct, the commercial risks faced and the markets in which they operate are disregarded. Under the proposal, the international standard arms-length approach to setting the interest rate on intragroup loans is abandoned in favour of a blunt approximation of the group's average cost of funds. BNZ considers that the arms-length principle should be preserved in setting interest rates on related party loans.

3.4 There is limited justification given in the Discussion Document for the departure from the arms-length principle. The primary reasons offered are that it can be difficult for IR to challenge uncommercial arrangements under the transfer pricing rules and that the highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply. While BNZ accepts that transfer pricing rules can sometimes be difficult to apply, that of itself is not good reason to abandon the arms-length principle which is a core concept in established transfer pricing and international taxation.

3.5 The OECD report "Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports" continues to support the arms-length approach to transfer pricing while acknowledging that application of the principle may be prone to manipulation. Rather than abandoning the principle, the OECD guidance authorises the disregarding of arrangements between associated enterprises for transfer pricing purposes when the transactions lack commercial rationality. This approach is included as a proposal in the recent Inland Revenue Discussion Document: "BEPS – Transfer pricing and permanent establishment avoidance", which proposes disregarding legal form if it does not align with the actual economic substance of the transaction.

3.6 In BNZ's view, the introduction of a reconstruction provision that enables the Commissioner to disregard transactions where the legal form does not align with economic substance ought to be sufficient to deal with the minority of multinationals setting excessive interest rates on related party loans. The proposed interest cap aims to counter the same mischief, only it is less targeted. BNZ does not consider there to be a compelling reason to have multiple tools to combat the same perceived mischief.

3.7 Finally, the fact that the Discussion Document excludes out-bound intercompany loans from the proposed interest rate cap serves to highlight that the interest rate cap is not a principled approach to setting interest rates on intercompany loans. If Government and the Commissioner are happy that the proposed interest rate cap ensures the interest rate on a related party loan is

"roughly in line with the interest rate the borrower would agree to with a third-party lender"1, then the approach should apply to both inbound and outbound loans.

Reconstruction provisions for uncommercial arrangements is a more targeted approach

3.8 The base erosion and profit shifting behaviour that the proposed interest rate cap is targeting is, according to the Discussion Document, that there is a "minority that engages in more aggressive tax practices"2 where "some firms have borrowed from their parents at high interest rates, resulting in large interest deductions in New Zealand"3. The Discussion Document does not suggest this is a widespread problem, rather, that a minority of firms are taking excessive interest deductions.

3.9 If a minority of taxpayers are setting excessively high interest rates on intercompany loans, the most appropriate response is a targeted anti-avoidance measure. A targeted response should be preferred over a rule that applies broadly to all taxpayers as the broad approach will adversely affect valid, justifiable transactions as well. This is a particular concern due to the high potential for double taxation (see below) that will arise under the proposed interest rate cap.

3.10 A sufficiently targeted anti-avoidance measure has been proposed in the TP Discussion Document in the form of a reconstruction rule. The Discussion Document acknowledges that the proposed reconstruction rule strengthens the existing transfer pricing rules against aggressive tax practices. However, it goes on to argue that stronger transfer pricing rules are inadequate because sufficient commercial pressures do not exist in a related party context and that as a consequence, unnecessary and uncommercial terms feature in some related party loans.

3.11 The operation of the proposed reconstruction provisions in the TP Discussion Document is not dependent in anyway on there being a commercial tension within a related party funding transaction. Acknowledging that the reconstruction proposals are still only proposals, BNZ does not expect that the presence or absence of commercial pressures in a related party funding arrangement would have any bearing on the ability of IR to invoke a reconstruction provisions. Conversely, the reconstruction provisions would seem to be specifically targeted at those related party funding transactions where, through the absence of commercial pressures, the terms of the funding arrangement are unreasonable and uncommercial.

3.12 The fact IR is able to identify the features it considers are uncommercial and unnecessary means there should not be a concern with identifying those funding arrangements it considers result in excessive interest deductions.

Double taxation

3.13 The proposals do not address the double taxation that will result when the interest rate cap applies to deny an interest deduction in New Zealand but where the overseas jurisdiction requires the loan to be priced at an arms-length.

3.14 An example of this would be where banking regulatory capital is obtained from an Australian parent company and that capital is in the form of subordinated debt. The Australian transfer pricing rules would require standard arms-length principles to apply such that the interest rate on the debt is a market rate of interest, having regard to the credit rating of the New Zealand bank and the subordinated terms of the loan etc. In order to comply with the Australian transfer pricing rules, the loan would likely be priced at a rate higher than the interest rate allowed by the

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[1] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 3.17
[2] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 1.4
[3] Government Discussion Document: BEPS – Strengthening our interest limitation rules, paragraph 1.4

proposed interest rate cap. This means an interest deduction will be denied in New Zealand but that same interest will remain taxable in Australia.

3.15 In addition, there does not appear to be any ability for an affected taxpayer to engage the mutual agreement procedures contained in New Zealand's tax treaties when there is a tension between the interest rates that each jurisdiction deems to be appropriate. BNZ strongly recommends that this position is reviewed and that IR ensures mutual agreement procedures are available to mitigate the double taxation risks.

3.16 A consequence of the double taxation outcome that will result is that the hurdle rate for investment into New Zealand increases. In the context of the Australian owned banks operating in New Zealand, this will transpire as an increase in borrowing costs for New Zealand businesses and homeowners.

Withholding tax implications

3.17 As proposed, New Zealand withholding tax (or Approved Issuer Levy) would continue to apply to the actual interest payments made regardless of the amount of interest deemed to be deductible for New Zealand tax purposes.

3.18 BNZ expects IR will take the position that it is appropriate for withholding tax to apply as there is still a transfer of value from the subsidiary to the offshore parent, i.e. there is effectively a dividend. However, if that argument is to hold, the withholding implications should mirror what would occur if a dividend was declared and paid. Under many of New Zealand's double tax treaties such a dividend would not be subject to New Zealand withholding tax.

3.19 BNZ submits that withholding tax should only apply to the deductible interest amount. This is consistent with other recent legislative changes to align the deductibility of interest and the impost of withholding tax.

Banking regulatory capital

3.20 BNZ submits that banking regulatory capital should be excluded from the interest rate cap. Banking regulatory capital has many of the features it does (i.e. subordination, longer terms, convertibility) purely because of the regulation imposed on New Zealand registered banks under RBNZ's prudential supervision framework. This is in contrast to the Discussion Document's contention that such features are used primarily to drive up the interest rate on related party funding.

3.21 The capital adequacy framework in New Zealand is based upon the Basel capital framework developed by the Basel Committee on Banking Supervision. The framework incorporates minimum capital ratios, defines what qualifies as qualifying capital, includes internal capital adequacy assessment processes, and includes a disclosure regime. It is highly prescriptive.

3.22 A consequence of the highly prescriptive nature of the capital adequacy rules, along with a relatively shallow debt market in New Zealand means that New Zealand registered banks do, and will, have subordinated related party debt. The debt is typically deeply subordinated, may be for terms exceeding five years and may include conversion features however these are purely to meet the requirements of the prudential regulatory regime, and not for the purposes of obtaining an excessive interest deduction in New Zealand.

3.23 To highlight this point, the following is an extract from Subpart 2B of the Reserve Bank of New Zealand Capital Adequacy Framework (Standardised Approach) - Document BS2B, issued November 2015, which defines the criteria for classification as Additional Tier 1 capital:

To qualify as Additional Tier 1 capital, an instrument must satisfy the following criteria:

(a) ....

(b) The instrument represents, prior to any conversion or write-off (refer subpart 2E and subpart 2F), the most subordinated claim in the liquidation of the registered bank after Common Equity Tier 1 capital. Nothing in this provision shall prevent one Additional Tier 1 instrument being subordinated to another Additional Tier 1 instrument.

(c) The paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of any member of the banking group or a related entity, or subject to any other arrangement that legally or economically enhances the seniority of the holder's claim vis-a-vis bank creditors. The instrument may not be subject to netting or offset claims on behalf of the holder of the instrument.

(d) The principal amount of the instrument is perpetual (i.e. there is no maturity date). However, the instrument may be callable or redeemable at the initiative of the registered bank after a minimum of five years from the date on which the registered bank irrevocably receives payment for the instrument. Despite anything in this subpart, an instrument may:

(i) provide for the registered bank to have a right to call or redeem the instrument within the first five years of issuance as a result of a tax or regulatory event. Instruments issued after 1 January 2016 must include as a term of the instrument that the instrument may not be callable as a result of a tax or regulatory event if that event was anticipated at the time of the issue of the instrument or if the event is minor (or words to that effect) ...

3.24 The requirements above mean that in order to qualify as Additional Tier 1 Capital, the debt must be, subordinated, unsecured and perpetual; all features the Discussion Document highlights as being used by multinational groups to artificially drive up interest rates on related party debt. In the context of banking regulatory capital, however, there is no real choice in the form of the debt that is being issued.

3.25 RBNZ also requires that related party debt that qualifies as regulatory capital is issued at an arms-length interest rate. As a rule, such debt would be priced based on the prevailing market interest rate on instruments with similar terms on the day the debt is issued. The proposed interest rate cap would put New Zealand registered banks in a position where two regulators impose directly competing rules in relation to the setting of interest rate on related party debt. It is therefore, not appropriate for banking regulatory capital to be captured by the proposed interest rate cap.

3.26 If the interest rate cap did apply, a consequence of disallowing interest deductions on banking regulatory capital would be an increase in the cost of funds to the New Zealand banks. Absent a change in the regulatory capital regulations, banks would still have limited choice in the types of regulatory capital they raise and would need to continue to issue related party debt that is subordinated, perpetual and/or convertible. The cost of the interest denial will inevitably flow on to the interest rates New Zealand registered banks charge to New Zealand businesses and homeowners.

3.27 Banks will typically hold a prudential buffer over and above the minimum capital requirements to ensure that the minimum capital ratios are not breached unexpectedly. It could be argued that in the absence of an interest rate cap banks would load-up on Additional Tier 1 capital issued to the Bank's parent company. However, Additional Tier 1 capital is more expensive than other forms of funding that does not qualify as regulatory capital. Holding excessive amounts of regulatory capital adversely impacts the New Zealand banks' financial performance as cheaper funding can be obtained. RBNZ imposes as a condition of registration on New Zealand banks the requirement for the board of directors of the New Zealand bank to act in the best interests of the New Zealand bank. This is outlined in the Reserve Bank of New Zealand Document BS14 – Corporate Governance:

Acting in best interests of the bank

(1) The aim of the conditions discussed above is to ensure as far as possible that the board collectively will, in practice, take decisions in the best interests of the bank, without undue influence from parties whose interests may diverge from the bank's. There is also a condition which prohibits the registered bank from having in its constitution a provision permitting a director, when exercising power or performing duties as a director, to act other than in what he or she believes is the best interests of the bank.

(2) Although a director of a company, when exercising powers or performing duties as a director, is normally required under the Companies Act 1993 to act in good faith and in what the director believes to be the best interests of the company, section 131(2) of the Companies Act allows a director of a subsidiary to act in a manner which he or she believes is in the best interests of its holding company even though it may not be in the best interests of the subsidiary, if expressly permitted by the subsidiary's constitution. Therefore this condition of registration prohibits the registered bank's constitution from allowing a director to act other than in the bank's best interests.

3.28 This requirement, to act in the best interests of the New Zealand bank, means that the board of directors could not agree to a course of action that involved a New Zealand bank having a preference to expensive related party debt where other alternative funding options are available.

3.29 Finally, as all the major retail banks in New Zealand are Australian owned, the argument that interest rates on intercompany regulatory capital might be set with a purpose of inflating interest deductions in New Zealand to the overall benefit of the worldwide group simply does not hold. The corporate tax rate in New Zealand is 28% while the corporate tax rate in Australia is 30%. Even if it were possible to inflate interest rates to achieve a tax advantage to the group (and it is not, given the regulatory conditions), it would not make economic sense to generate excessive interest deductions in the lower tax jurisdiction.

Related party definition

3.30 If the interest rate cap proposal proceeds, BNZ submits that the definition of related party debt should be amended to exclude debt raised from third parties by a subsidiary of a New Zealand registered bank and on-lent to the New Zealand bank. This is necessary because it is common for New Zealand banks to have a subsidiary that issues debt to the external market which is on-lent to the New Zealand bank. In these situations, there is a clear market interest rate for the debt (the rate on the debt issued to the external market) and it is that market interest rate that should be permitted for tax purposes.

3.31 Such an approach would be consistent with an underlying premise of the interest rate cap which is to treat the group of companies as a single economic entity rather than independent entities dealing at arms-length.

Interest rate cap should operate only as a safe-harbour

3.32 BNZ submits that the proposed interest rate cap should only operate as a safe harbour.

3.33 BNZ agrees with comments in the Discussion Document that it can be a complex and resource intensive exercise to establish what is an arms-length interest rate for an intercompany loan. This holds true for taxpayers and IR. Therefore, BNZ can see some merit in introducing an interest rate cap as a safe-harbour.

3.34 Under a safe-harbour approach, taxpayers who do not wish to undertake full transfer pricing analysis to determine an arm's length price would be free to apply a rate that meets the interest rate "cap". However, a taxpayer would be able to exceed this safe harbour if an arms-length interest rate (applying the transfer pricing rules) is higher than the interest rate cap.

3.35 The main benefit of this is approach is that the arms-length principle is preserved, and taxpayers would have a choice as to whether the benefits of undertaking a transfer pricing exercise to validate a higher arms-length interest rate exceeds the cost of doing so. It would also partially address the concerns BNZ has with the double taxation issues as a taxpayer would not be limited to the capped interest rate if there was a significant risk of double taxation under that approach (i.e. where the other jurisdiction required a higher interest rate under its standard arms-length based transfer pricing rules).

3.36 It would also mean that IR could focus its compliance / audit resources on those taxpayers who wish to use a rate over the safe-harbour but still allow taxpayers to use a greater interest rate where it is appropriate to do so on an arm's length analysis.

4.0 CONCLUSION

4.1 BNZ is pleased to provide this submission and the information it contains. BNZ is available to discuss any issues raised.

4.2 Should IR have any questions in relation to this submission, please contact:

Campbell Rapley
Head of Tax, BNZ

DDI: 9(2)(a) [redacted]
Mobile:
Email: campbell_rapley@bnz.co.nz

#021

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A RESPONSIBLE CARE® COMPANY

28 April 2017

Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

sent via email: policy.webmaster@ird.govt.nz

Dear Deputy Commissioner

BEPS – Strengthening our interest limitation rules

Thank you for the opportunity to comment on the Government's discussion document: BEPS – Strengthening our interest limitation rules (**Discussion Document**).

We would like to make the following submissions:

- the interest rate cap should not be introduced because it conflicts with the arm's length principle that is accepted globally for pricing related-party debt and has potential double tax implications (Chapter 3 of the Discussion Document); and
- the ability for taxpayers to use net current asset value for thin capitalisation calculations should be retained (Chapter 5 of the Discussion Document); and
- Grandparenting provisions should take into account existing Advance Pricing Agreements ('APA') and loan terms; and
- Gross assets should not be adjusted for non-debt liabilities.

We set out some background information about us, and our more detailed submissions, below.

1. About us

Methanex New Zealand Limited (MNZ) is ultimately owned by Methanex Corporation, a Canadian corporation which is listed on the Toronto Stock Exchange and the NASDAQ Global Market. Methanex Corporation, together with its global subsidiaries (the Group), produces and sells methanol globally. MNZ owns two methanol facilities in NZ, and produces methanol primarily for export to markets in Japan, Korea and China. It's estimated methanol production adds $650 million to New Zealand's GDP each year, and sustains 1200 jobs directly and indirectly.[1]

Methanex Asia Pacific Limited, the immediate parent of MNZ, has advanced substantial intra-group funding to MNZ. MNZ has an APA with Inland Revenue in respect of this funding dated 23 December 2013.

[1] Economic Impact Analysis undertaken on behalf of Methanex by Business and Economic Research Limited ("BERL"), March 2013

Methanex Corporation subsidiaries operate in multiple jurisdictions globally and therefore it has considerable experience in operating within many legal and tax systems. In this context, Methanex Corporation has admired the stability of the NZ legal and tax systems and in particular the robustness of the tax policy/change process. We support the Government's desire to protect the tax base and ensure multinationals "pay a fair amount of tax". It has been on this basis that MNZ has for many years adopted an open and transparent dialogue with the Inland Revenue Department in relation to its tax profile and any proposed transactions/events. It is with this background that we respectfully express our surprise and concern about the proposed speed and novel approach being proposed in parts of the Discussion Document. The NZ economy is heavily reliant on inward investment with the associated benefits, economic and otherwise. There is some risk that the current proposed approach undermines the confidence of foreign investors in NZ.

2. An interest rate cap should not be introduced – debt should be priced on an arm's length basis

Intra-Group funding is priced on an arm's length basis in most of the other jurisdictions in which we operate. The arm's length principle may be applied slightly differently in different jurisdictions, with the result that interest income may not match interest deductions under domestic laws in all cases. However, double tax agreements override domestic laws to require such interest to be dealt with consistently between the two relevant jurisdictions (where the arm's-length approach is being followed) through corresponding adjustments and access to the mutual agreement procedure.

Our primary concern with the proposed interest rate cap is that it would be a fundamental shift away from pricing debt on this basis, giving rise to a risk of double taxation where interest income and interest deductions do not match, that cannot be mitigated through a double tax agreement. For this reason, the interest rate cap should not be introduced.

Pricing intra-group debt using arm's length principles (as strengthened by the Government's proposals in relation to transfer pricing) is consistent with the OECD's work under its BEPS project. Under Actions 8-10, the OECD concluded that the arm's length principle (based on economic reality rather than legal form) was the most effective and efficient way to price intra-group transactions. We understand that the OECD will be carrying out further work this year in relation to the transfer pricing aspects of financial transactions between related parties.

Pricing debt on this basis is also consistent with the OECD's work on BEPS involving interest deductions (Action 4). The OECD recognised that thin capitalisation rules which limit the level of debt (as New Zealand's rules do) do not address BEPS concerns where an excessive rate of interest is applied to a loan, and suggested that a further mechanism, such as an arm's length test, would be needed to address this particular concern.[2]

Lastly, imposing the Methanex Corporation credit rating on the NZ subsidiary is a blunt approach that ignores the significant difference in risk profiles between a global parent and a manufacturing subsidiary. Throughout our APA process in 2013 undertaken with Inland Revenue staff, it was clearly understood that the parent credit rating could never be achieved by the stand-alone subsidiary. It is a significant shift to now propose that the parent credit rating determines the interest rate cap – we are not aware of this approach being applied in any of the other jurisdictions we operate in.

[2] OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update, paragraphs 58 & 59. In paragraphs 12-15 of that paper, the OECD commented that an arm's length amount of debt (and similar tests) on its own would not address all of the OECD aims of Action 4, but that it might still have a role to play alongside other tax policy goals. These comments do not indicate that arm's length principles should not be used to price debt.

3. Ability to use market values should be retained

The Discussion Document, at paragraph 5.25 states "…we consider that the valuation method chosen for financial reporting purposes will be the one that most fairly represents the value of a company's assets". This is not correct. Your Tax Information Bulletin: Volume Seven, No.11, Page 19 (March 1996) correctly said (when the thin capitalisation rules were first introduced) – "…it is recognised that the valuations for financial reporting purposes are likely to have been adopted for other than tax reasons". Consequently it was concluded that a taxpayer should be able to use net current value/market value if that taxpayer could have adopted it for assets under GAAP (now IFRS) but has chosen not to.

MNZ values its assets at historical cost for NZ financial reporting purposes. We are permitted to use market value under IFRS (IAS 16 and IAS 8). However, we choose not to do so, because there is no benefit to the Group or its shareholders in incurring the additional expense of preparing NZ financial statements on this basis. The group's published financial statements are prepared by Methanex Corporation on a consolidated basis, and these are the financial statements that are generally used to report to shareholders and for other purposes. MNZ's individual entity accounts effectively serve only to meet NZ Companies Office obligations.

The ability to use net current value/market value where permitted by IFRS should be retained. We understand that the Government's concern is that valuations used for thin capitalisation purposes but not for financial reporting purposes may not be subject to a sufficient level of independent scrutiny. We don't believe this should be a concern for MNZ because MNZ use asset valuations undertaken by a qualified valuer for thin capitalisation purposes.

If the ability to use net current value is not retained, taxpayers will, for tax reasons, adopt net current value for financial reporting purposes despite it making no sense for commercial reasons. This change of accounting policy in financial statements under IAS 8 can be made (ie. it is elective) if the result is more reliable or relevant. This will particularly be the case when there is a significant difference between the historical cost and market value of assets.

We strongly submit that the ability to use net current values/market value for thin capitalisation purposes needs to be retained.

Concerns could be addressed by requiring valuations being adopted for thin capitalisation purposes to be supported by a valuation from a registered valuer, or a similarly qualified independent person. As noted above, this is our current approach (which has been fully disclosed to Inland Revenue).

4. Grandparenting

The Discussion Document states that the proposals will apply from the beginning of the first income year after enactment. Assuming that the proposals proceed, we consider that this application date is too soon in the context of the significance of the changes being implemented. It does not allow sufficient time for us to model the impact and plan a potential restructure or refinancing in response. We submit that the application date for any new policy should be at least one income year post enactment.

There should also be grandparenting for existing APAs until the end of the currently agreed term of the APA or the term of the relevant loan, whichever is the longer. Any proposal to not respect existing APAs undermines the credibility of the tax system. We went to significant time (our global treasurer travelled to NZ to engage in the APA process) and cost to agree the APA and strongly believe APAs should remain in place. We also consider that existing financing arrangements covered by an APA should be grandparented to their original/current term where that exceeds the current APA term. This provides certainty for the multinational and allows time to refinance.

5. Treatment of non-debt liabilities

We do not consider that requiring gross assets to be adjusted for non-debt liabilities is consistent with the core objectives of a thin capitalisation regime. It arbitrarily distorts the thin capitalisation percentage depending on the timing and the make-up/nature of liabilities recorded for accounting purposes under IFRS.

We also consider that if there is a change to net assets (ie. deducting non-debt liabilities most of which will be disclosed at market value), that to ensure consistency, asset values should also be able to be expressed at market value (net current value). Finally, liabilities not funding a taxpayer's balance sheet should be excluded eg. deferred tax liabilities (as per the Australian rules).

Conclusion

We trust you find our submissions useful. Please contact me if you would like to discuss any aspect further.

Yours sincerely

Kevin Maloney
Managing Director
Methanex NZ Limited

#022

Submission

to the

Inland Revenue Department

on

BEPS – Strengthening our interest limitation rules: A Government Discussion Document

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28 April 2017

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fifteen registered banks in New Zealand are members of NZBA:

- ANZ Bank New Zealand Limited
- ASB Bank Limited
- Bank of China (NZ) Limited
- Bank of New Zealand
- Bank of Tokyo-Mitsubishi, UFJ
- Citibank, N.A.
- The Co-operative Bank Limited
- Heartland Bank Limited
- The Hongkong and Shanghai Banking Corporation Limited
- JPMorgan Chase Bank, N.A.
- Kiwibank Limited
- Rabobank New Zealand Limited
- SBS Bank
- TSB Bank Limited
- Westpac New Zealand Limited.

Background

3. NZBA welcomes the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on "BEPS – Strengthening our interest limitation rules: A Government Discussion Document" (**Discussion Document**).

4. NZBA appreciates the opportunity to have discussed the Discussion Document with IRD Officials to date and welcomes the opportunity to discuss any of our feedback directly with IRD Officials. As outlined in our feedback, we recommend ongoing discussions with IRD Officials on this topic as the proposals develop. In this regard, please contact:

Philip Leath
Chair of NZBA Tax Working Group
GM, Tax – ANZ
04 436 6493 / 021 280 4717

General Comments

5. As a general comment, NZBA supports the ongoing work of the OECD and IRD to address valid concerns over base erosion and profit shifting (**BEPS**), including shifting taxable income out of New Zealand through aggressively priced related party debt. However, addressing valid concerns should be targeted at the minority that engage in aggressive tax practices and not be applied across the board to all related party debt, the majority of whom represent legitimate commercial behaviour, which will impose an unwarranted cost on the New Zealand economy. This is particularly pertinent for the New Zealand banking industry as the primary financial intermediary for New Zealand individuals and businesses. The New Zealand banking industry is subject to significant prudential regulation in respect of the manner and source of its funding in order to ensure stability of the New Zealand financial system. The regulation already imposed on the New Zealand banking industry means the concerns stated in paragraphs 3.3 to 3.14 of the Discussion Document do not arise in the case on the New Zealand banking industry.

6. This submission centres upon the interest limitation proposals in chapter 3 of the Discussion Document.

Submissions

7. NZBA outlines below key submission points in respect of the potential outcomes from the interest limitation proposals on bank funding and also bank regulatory capital.

   a. NZBA submits that New Zealand banking groups should be excluded from the interest limitation proposals.

      i. New Zealand banking groups obtain the majority of their funding from various non-related party sources. The Reserve Bank of New Zealand (**RBNZ**) requires diversity in the funding utilised by New Zealand registered banks to ensure liquidity of inwards and outwards funding flows (often referred to as the minimum core funding ratio).[1] The calculation of the core funding ratio provides a preference for deposit funding compared to wholesale funding (which includes related party funding in the core funding ratio calculation). As such, New Zealand registered banks are unable to obtain a significant portion of funding from related parties.

      ii. New Zealand registered banks are subject to the RBNZ's conditions of registration which require New Zealand registered banks to act independently and in their own best interests. It follows that aggressively priced related party funding would not be permissible. For regulatory, commercial and tax reasons, related party debt must bear arm's length terms and interest. Hence, in light of paragraph 3.11 of the Discussion Document, it is not correct that New Zealand banking groups are indifferent to or accept "unnecessary or uncommercial terms".

      iii. Further, the Australian owned New Zealand banks face limits on exposures their parent can have to New Zealand banks by the Australian Prudential regulator (APRA). APRA restricts the exposure of an Australian Deposit Taking Institution (**ADI**) in their New Zealand subsidiaries to 50% of the

[1] Refer RBNZ Document BS13 (Liquidity Policy)

amount of Level 1 Capital of the ADI[2]. Therefore, existing prudential regulation precludes the exact type of behaviour the IRD are seeking to address through the proposals. New Zealand banking groups are not the target of the interest limitation proposals such that their exclusion is justified.

iv. The proposals seek to apply an offshore parent's senior unsecured debt interest rate as an approximation for the worldwide group's cost of funding and any interest paid to offshore related parties at a rate above this (plus a margin) will be disallowed as a deduction. Economically, this axiomatically assumes that a majority of the New Zealand foreign owned subsidiary's debt is sourced from their offshore parent and that the New Zealand subsidiary would only seek, in a commercial sense, senior unsecured debt from the market. However, this is not the case in the New Zealand banking industry. As above, the New Zealand banking industry primarily sources funding from unrelated parties. Further, New Zealand banks are required to hold, at least, 10.5% regulatory capital over risk weighted exposures, of which 7.0% must comprise Common Equity Tier 1 Capital (ordinary shares and retained earnings; not debt). The balance of regulatory capital, over and above Common Equity Tier 1, takes the form of Additional Tier 1 (**AT1**) or Tier 2 (**T2**) capital. RBNZ (in applying the Basel III framework) requires AT1 and T2 to include specific features, including subordination, permanence (with a minimum 5 year term), flexibility of payment (e.g. AT1 must include terms whereby interest is payable at the option of the issuer and be non-cumulative) and loss absorbency measures. These features are mandatory and, as a consequence of these features, regulatory capital is priced well above senior unsecured debt.

v. While it is necessary that New Zealand banks have diversity of funding sources and can be restricted as to the level of funding available from their parent, it is logical for New Zealand banks to apply such restriction primarily to source regulatory capital from their offshore parent. This is because:

- the New Zealand market is not sufficiently liquid to fund all the New Zealand bank's regulatory capital needs (particularly given the idiosyncratic complexity and cost of issuing such capital);
- of the regulatory benefits of a parent raising such capital (i.e. a parent bank may not be able to recognise 100% value of regulatory capital externally issued by its New Zealand subsidiary bank);
- it reduces the complexities of multiple prudential regulatory rules applying to the same capital issuance (which is the case when the New Zealand bank issues regulatory capital externally);
- the commercial undesirability for a New Zealand bank to issue regulatory capital into its parents' home market; and
- generally, the offshore parent bank can raise regulatory capital more cheaply than the New Zealand bank (particularly in international markets).

[2] Refer APRA's Prudent Standard APS 222 (Associations with related Entities). The ADI parents of the 4 major New Zealand banks are subject to additional tighter related party exposures which require that, by 1 January 2021, no more than 5% of the Australian ADI's Level 1 Tier 1 Capital comprise non-equity exposures to its New Zealand operations, including New Zealand holding companies (excluding regulatory capital instruments).

vi. Consequently, a significant source of funding of New Zealand banks' regulatory capital is from their offshore parent. This is due to commercial and regulatory reasons and is not driven by tax considerations. As such, applying an offshore parent bank's senior unsecured rate to such funding is inappropriate as it does not reflect the predominant type of debt sourced from offshore parents in terms of both the legal and economic substance of such debt. As above, such debt is obtained from offshore parent banks for commercial and regulatory reasons.

vii. NZBA considers the above position is not altered if the New Zealand registered bank is owned by an offshore parent bank via a New Zealand holding company (which is not a registered bank). It is possible that a foreign parent provides regulatory capital to its New Zealand subsidiary bank by providing non-regulatory debt funding to the New Zealand holding company which, in turn, provides the regulatory capital funding to the New Zealand registered bank. While the debt funding to the New Zealand holding company cannot be regulatory capital, such debt does need to closely mirror the terms, and therefore pricing, of the regulatory capital issued to the New Zealand registered bank. This mirroring is important for commercial reasons to ensure the New Zealand holding company can "pass through" the risk of the regulatory capital instrument to the debt it has issued to ensure, amongst other things, the solvency of the New Zealand holding company. For example, the New Zealand holding company faces a risk of non-payment of interest on the regulatory capital funding to the New Zealand bank. If this risk is not passed on, it could become insolvent. Further, the use of a New Zealand holding company results in a similar position, economically and tax wise, as if the offshore parent bank provided regulatory capital direct into the New Zealand bank (and not through the New Zealand holding company).

viii. If New Zealand banking groups are not excluded from the proposals, foreign owned New Zealand banking groups would suffer adverse funding and inconsistent tax outcomes compared to other industries. Foreign owned New Zealand banking groups must hold regulatory capital and do not have the flexibility that many other industries have of restructuring related party debt. As such, foreign owned New Zealand banking groups will be required to pay interest, at commercial rates (as required under the RBNZ conditions of registration as well as for tax transfer pricing purposes), on bank regulatory capital to their parent but be denied a full interest deduction for doing so.

ix. The proposals, if they did apply to New Zealand banking groups, may drive a perverse economic position in that New Zealand banking groups may be forced to directly issue regulatory capital in international markets at a higher pre-tax cost (than if the regulatory capital was sourced from its parent) to obtain a lower post tax outcome (than if the regulatory capital was sourced from its parent). Such a position appears contrary to good tax policy.

x. NZBA considers that excluding New Zealand banking groups from the interest limitation proposals may not be contrary to OECD recommendations. The OECD public discussion document on Action 4[3]

[3] OECD, BEPS Action Item 4: Approaches to address BEPS involving interest in the banking and insurance sectors

highlighted the difficulty on applying interest limitation rules in the banking industry, in particular noting that *"…excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low …"*. In this regard we also refer to the submissions from the Australian Banker's Association (**ABA**) and the International Banking Federation (**IB Fed**) on the OECD's Action 4[4].

b. If our submission that New Zealand registered banks should be excluded from the interest limitation proposals is not accepted, NZBA submits that bank regulatory capital should be excluded from the proposals, for the same reasons outlined above. NZBA considers that the combination of the existing prudential regulation and the New Zealand transfer pricing rules provides sufficient comfort and power to the IRD to ensure arm's length pricing is applied. This is particularly the case in light of the proposed enhanced powers for the IRD in respect of transfer pricing as outlined in the *"BEPS – Transfer pricing and permanent establishment avoidance: Government Discussion Document"*.

c. If our submissions above are not accepted, NZBA submits that the interest limitation proposals should apply as a safe harbour only and not over ride application of the transfer pricing rules or prevent use of a true commercial arm's length arrangement. NZBA considers that such an approach would minimise the compliance burden for both taxpayers and the IRD by allowing taxpayers to fall within the interest limitation rule and, therefore, not be required to apply transfer pricing rules. It would also provide flexibility for taxpayers to apply the arm's length principle in respect of instruments where the interest limitation proposal would not reflect arm's length commercial terms and price (such as bank regulatory capital).

   Further, NZBA is concerned that as a domestic anti-avoidance measure, the interest limitation proposals would unilaterally apply outside New Zealand's Tax treaty network. As it is necessary for New Zealand banking groups to pay arm's length interest rates to related parties (refer 7a ii above), the interest limitation proposals would result in a unilateral tax impost (i.e. the double tax outcome referred to above) that could not be corrected via Tax Treaty competent authority procedures.

d. If none of the above submissions are accepted, NZBA submits that the interest limitation rules should not apply to existing related party debt instruments, or at least not to existing related-party bank regulatory capital issuances. Contrary to the statement in the Discussion Document that the proposed implementation timeframe of the proposals will provide sufficient time to companies to rearrange their affairs, New Zealand banks will not have this option. It is not possible to restructure bank regulatory capital with a different instrument predominantly due to the inability to call such instruments. Further, if the New Zealand banks were forced to call and re-issue such instruments, significant liquidity pressures would arise which may result in very highly priced capital being raised in international markets and place a significant strain on the security of the New Zealand banking system.

[4] Refer to pages 36-48 (for the ABA submission) and pages 179-182 (IB Fed) of the "Comments received on Public Discussion Draft BEPS Action 4 – available at http://www.oecd.org/ctp/aggressive/public-comments-received-on-the-discussion-draft-on-approaches-to-address-beps-involving-interest-in-the-banking-and-insurance-sectors-under-action-4.htm

e. NZBA understands from discussions with Officials that the proposed "related-party" debt definition at paragraph 3.43 of the Discussion Document should not extend to capture debt raised by offshore branches of subsidiaries in the New Zealand banking group for the purposes of funding the New Zealand banking group. NZBA supports this approach as such funding is raised by the New Zealand banking group, for the New Zealand banking group.

f. NZBA recommends extensive consultation occurs on any further development of the interest limitation proposals, importantly before legislation is drafted, and that any draft legislation/exposure draft is made available to interested parties for comment prior to introduction to Parliament as a Bill. We would be very happy to set up working group meetings with appropriate representatives from members of the NZBA in this regard.

28 April 2017

Interest limitation #023
TP +PE #012

BEPS – Transfer pricing, PE avoidance & Interest limitation rules

C/- Deputy Commissioner, Policy and Strategy

Inland Revenue Department

PO Box 2198

Wellington 6140

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Transfer pricing, PE avoidance and proposed interest limitation rules

The American Chamber of Commerce in New Zealand Inc appreciates the opportunity to comment on New Zealand's proposals for international tax reform released on 3 March 2017.

The American Chamber of Commerce in New Zealand Inc – better known as AmCham – has been New Zealand's number one business organisation for the promotion of trade and investment between the United States and New Zealand and the Asia Pacific region for over 50 years. We are "The Voice of American Business in New Zealand". Our members represent turnover in excess of NZ$50 billion and over 100,000 employees.

Our submission covers two Government discussion documents – BEPS – Transfer pricing and permanent establishment avoidance and BEPS – Strengthening our interest limitation rules.

We provide comments on the overall approach which we recommend should be adopted by the Government, supplemented by our recommendations for changes to the specific proposals regarding permanent establishments ("PEs"), interest limitation rules and transfer pricing.

1. Executive Summary

Inbound investment from the United States is important to New Zealand – both in absolute dollars (at least 8% of total foreign direct investment ["FDI"]) and through wider contributions to the economy and society. Tax policy should recognise the importance of inbound FDI while ensuring that inbound investors, including our members, pay their "fair share".

Fairness and certainty considerations lead us to supporting implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem. However, there is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

With regards to the proposals concerning PE avoidance:

- *We support enforcement of the accepted international definition of a PE. This is best done by way of implementing the Multilateral convention to implement tax treaty related measures to prevent BEPS rather than a unilateral PE anti-avoidance rule.*

- *Should New Zealand proceed with the PE anti-avoidance rule, clarity of scope and application is essential, there should be a transitional rule to allow our members the time to restructure and guidance from Inland Revenue regarding profit attribution would be welcome.*

We agree with aspects of the proposed reforms to interest limitation rules but wonder if the Government has lost sight of the strength of New Zealand's existing thin capitalisation rules. Members have major concerns regarding the proposed limit on interest rates on related party loans, as it will lead to double taxation in many cases and is incompatible with the arm's length principle.

We agree in principle with the change to require total assets to be calculated net of non-debt liabilities, but our members should be given time to adjust their existing arrangements. Other conditions for our support include that the ability to use net current asset values is retained, deferred tax liabilities are excluded from the definition of non-debt liabilities and existing financing arrangements are grandparented for an extended period.

With respect to transfer pricing, we support aligning New Zealand's transfer pricing rules to OECD Guidelines. Better alignment with the Australian transfer pricing rules is also appropriate, but only to the extent that those rules remain consistent with the principles set down by the OECD and do not seek to target a greater than arm's length proportion of profit.

Members do have concerns regarding the references to limited risk distribution ("LRD") structures. LRD structures commonly reflect commercial substance and are frequently embedded within a global group's worldwide framework. The LRD structure is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken is often relatively low in terms of value-add.

Members also see a number of the administrative measures proposed as inappropriate. We have concerns regarding penalties for not providing information, the factors leading to a finding that a taxpayer is non-cooperative, Inland Revenue's additional information gathering powers and the enforced early payment of tax in dispute.

We expand on these issues below.

2. Importance of New Zealand/United States relationship

The United States is New Zealand's second largest source of foreign direct investment, representing at least 8% of total FDI.

Many American inbound investors create substantial value through their business activity here, over and above the tax paid, in ways not visible through financial statements alone.

Tax policy should take account of these hard to measure spillover effects while ensuring that inbound investors continue to pay their fair share.

As the world has become more interconnected FDI has increasingly become a hot topic. For New Zealand how we connect with the world is a major issue since we import most of our technology and have a relatively shallow domestic capital base.

New Zealand–United States trade and investment has a considerable impact on the New Zealand economy. The Government has acknowledged our tax settings must "be consistent with maintaining New Zealand's position as an attractive location to base a business." There is a broad consensus that taxation is a significant factor in location decisions regarding inbound investment.

United States companies operating in New Zealand account for investment totalling in excess of NZD 12.6 billion and thousands of jobs. Direct investment in New Zealand is mostly in the finance/insurance and manufacturing sectors, with many investments having some degree of mobility. The United States accounts for at least 8.0% of foreign direct investment into New Zealand. This figure is likely to be materially understated as it excludes investment ultimately sourced from the United States but routed via third countries such as Australia and Singapore. Inland Revenue's own statistics show that, of the 314 foreign owned groups completing its international tax questionnaire, some 59 (or 19%) have ultimate American ownership.

The United States has become New Zealand's third largest trading partner, with trade totalling in excess of NZD 11 billion. In particular, New Zealand's largest imports of tangible goods from the United States include aircraft, jets, motor vehicles, medical instruments, food and appliances.

Our members' businesses have a positive impact on New Zealand society in many ways. Technology companies among our membership are commonly singled out during tax debates due to their digital nature. Yet these members belong to a sector having a transformative effect on the New Zealand economy, with the benefits from their presence extending well beyond New Zealand's receipt of corporate income tax.

Traditional economic and accounting indicators can underplay this effect and lead to the importance of inbound investment being underplayed. The digital economy in particular has the potential to drive future economic growth and productivity when it is adopted by businesses and consumed by users, whereas a large portion of the value of the digital economy goes unmeasured in today's economic indicators. For example:

• In terms of economic development, the digital economy can help alleviate the "double tyranny" of New Zealand's relative size and distance that affects businesses;

• Consumer benefits of digital communication are seen in increased convenience, better access to information, well informed decisions and more time saved in our daily lives; and

• With respect to transport, better mapping technology enables improved navigation and helps people find local businesses and tourist destinations.

AmCham consider that it is legitimate for the Government to take into account the wider spillover effects of our members' inbound investment when setting tax policy. We emphasise that we are not seeking any form of tax break or incentive: it is important that taxes are fair and seen to be fair. Our members are happy to pay their "fair share" in accordance with legislation.

3. Overall comments on the approach taken in the discussion documents

AmCham supports implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem.

Our members do not accept that aggressive tax practices are commonplace in New Zealand.

There is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

Today's business structures have evolved within a dated tax system and everyone will benefit from a simpler, more transparent, tax system.

The members of AmCham support the work of the Organisation for Economic Co-operation and Development ("OECD") and the G20 towards coordinated tax reform to ensure that global tax rules keep pace with business evolution. We recognise that consistent and fair taxation of multinationals has become more difficult in recent years. We also note the Government's consistent support for, and major policy contribution to, the OECD's work.

AmCham therefore agrees a proportionate implementation of the OECD recommendations is the right tax policy for New Zealand.

Keeping the Government's response proportionate to the size of the problem, while not deterring inbound investment, will be crucial. To this end, we agree with the Government that the majority of multinational companies operating in New Zealand comply with their tax obligations and with the

Minister of Revenue that "most foreign-owned firms operating here have relatively conservative debt positions and pay significant amounts of tax." We note further recent research conducted by EY which supports the conclusion that the majority of multinationals are not loading their New Zealand subsidiaries with excessive interest-bearing debt and that the majority have an effective tax rate close to, or equal to, the New Zealand corporate tax rate. While the evidence is not fully conclusive, AmCham does not accept that aggressive tax practices are prevalent in New Zealand.

We are further concerned that measures enacted unilaterally in New Zealand will over time have a similar impact on our New Zealand members operating in overseas jurisdictions. Should all countries implement the full package of measures proposed in New Zealand, such as the interest rate cap or anti-avoidance source rule, double taxation appears inevitable.

AmCham therefore considers it essential for New Zealand to take a measured approach and to stay within international norms. Governments should harmonise tax rules so that businesses can continue to create value. Fragmentation along country lines puts this value at risk. Unilateral action by New Zealand in addressing perceived base erosion and profit shifting ("BEPS") will be harmful if it also creates double taxation. A coordinated approach to BEPS will lead to more certainty for businesses, more efficient economic outcomes and growth, fewer cross-border tax disputes between revenue authorities and a higher global tax-take.

AmCham also endorses New Zealand's international tax framework. We consider the Government needs to confirm that it is open for business, consistent with New Zealand's taxation framework for inbound investment. Foreign businesses will respond favourably to certain and predictable tax laws in New Zealand. The benefits of foreign direct investment are endorsed in the discussion documents.

We note that the package is a powerful combination. It has gained international attention, and will put New Zealand at the forefront of BEPS implementation worldwide.

Given the substantial impact that some components of the package will have, we suggest that the Government consider whether any measures can be targeted at highly geared companies which have sought aggressively to minimise their New Zealand tax liability.

Finally, we support the consultative process adopted by the New Zealand Government.

4. Permanent establishment avoidance

Support for rule which enforces the accepted international definition of a permanent establishment

We agree that economic activities which should result in a PE in New Zealand should be subject to tax here. We therefore support a rule which enforces but does not widen the accepted international definition of a PE in substance.

We further agree that there is no need for a separate diverted profits tax. That said, the proposed PE anti-avoidance rule does replicate elements of the United Kingdom diverted profits tax, notably sharing many features with Australia's multinational anti-avoidance law.

We highlight, however, that New Zealand's implementation of the Multilateral convention to implement tax treaty related measures to prevent BEPS has the potential to address most, if not all, of the attempts to flout PE rules. That approach, being the coordinated international response, is the appropriate mechanism by which to enforce New Zealand's PE rules.

The introduction of more robust transfer pricing rules as proposed in the discussion document will also counteract the need for a specific PE avoidance rule. In particular, the discussion document indicates that the existence of a "number of well paid employees" would be an indicator of the existence of a PE. This could be addressed through the transfer pricing regime, and strengthened transfer pricing rules will assist Inland Revenue in relation to enforcement.

We are concerned that implementation of a unilateral response such as the new PE avoidance rule will impede the coordinated global response to BEPS. We therefore do not support its introduction at this time.

Uncertainty will not lead to good tax administration

There is a risk that vague and uncertain wording within the legislation could lead to disputes about the nature of activities being performed by taxpayers in New Zealand. In particular, a number of phrases and concepts central to the operation of the rule ought to be defined, including "commercially dependent", "in connection with", "low tax jurisdiction", "high paid employee" and "specialised services".

As an example of uncertainty, consider the proposal that an "arrangement involving third party channel providers" should necessarily result in a PE. Any such investigation would be a fact-specific enquiry and would depend on the activities provided by related party and third party channel providers. It will not always be clear whether the related party is performing "sales promotion and services", and there will inevitably be cases where the activities in New Zealand are in reality something less than this, or where the non-resident and the third party are in fact not working together to sell the goods or services to the end customer. The legislation, or guidance supporting the legislation, should be clear as to what kinds of specific arrangements give rise to a deemed PE.

If PE anti-avoidance rules are uncertain or difficult to apply, then the corresponding compliance costs could potentially outweigh the gains to the Government from more tax being paid here. Uncertainty in the rules could dissuade investment into New Zealand. Further, we highlight Inland Revenue's expectations regarding initiatives to tackle complex technical issues (such as PE anti-avoidance). The Commissioner of Inland Revenue is required to collect over time the highest net revenue practicable within the law having regard to the compliance costs incurred by taxpayers. Inland Revenue's

unaudited target return on income for additional funding voted by the Government in 2015/16 was $13.00 per dollar spent, on the basis of the economic inefficiencies involved in chasing down the last dollar of revenue. There is risk that attempted enforcement of the PE anti-avoidance rule will fall short of Inland Revenue's targets.

An ambiguous rule, combined with the proposed 100% penalty, could dissuade investment in a legitimate PE structure, within New Zealand's double tax agreements, on the mere potential that New Zealand would take unilateral action. This would not benefit tax enforcement, the New Zealand economy or our members.

We submit that taxpayers should be able to obtain confirmation from Inland Revenue that the PE avoidance rule would not apply in respect of a particular business structure. The process should operate similarly to an Advance Pricing Agreement ("APA") for transfer pricing purposes, and would add clarity for business with unique circumstances that risk breaching the proposed rule.

Changes to group structure will take time

Reorganising a global supply chain can be a complex business taking a substantial amount of time. New Zealand will often be a small component of a much larger supply chain. The effect of reorganising a global supply chain in a short period of time would be exacerbated for our multinational members operating in a larger number of countries.

We are also concerned that the proposed PE anti-avoidance rule could apply to members whose existing investment structures have previously been reviewed by Inland Revenue by way of a ruling, tax audit sign-off or an APA.

Further, the proposed 100% penalty applicable would present a punitive outcome for such taxpayers with a history of complying with New Zealand tax law if it is not possible for a multinational to reorganise its supply chain before the PE avoidance rule is implemented.

Additional guidance required on profit attribution

We anticipate that multinationals will engage more frequently in disputes with revenue authorities regarding the attribution of profits across jurisdictions.

It is important that the New Zealand Government consider the risk of double taxation where its preferred method of profit attribution differs from that applied in the jurisdiction of the foreign entity.

In light of these substantial proposed changes to the rules around PEs, it would be timely for Inland Revenue to provide additional guidance around the attribution of profit to a New Zealand PE.

5. Interest limitation rules

No case for interest rate cap

Limiting interest deductions based on credit rating within wider group is uncommercial, a departure from the arm's length principle and is likely to lead to cross-border disputes and double tax.

Our members find that there are many circumstances in which a foreign investor might want to invest in New Zealand through debt funding which should appropriately be priced at an interest rate higher than its group cost of funds. The New Zealand entity might be a high credit risk, for example a start-up or different industry. New Zealand is also a small, isolated, market and presents more risk to a (say) United States investor for which the next best alternative would be to expand its existing operations in the United States.

In such circumstances, a third party bank would conceivably lend to the New Zealand subsidiary at an interest rate much higher than the parent company's cost of funds. It will therefore often be more cost-effective for the parent company to provide funding directly to New Zealand. We anticipate that for our members providing finance into New Zealand, double taxation is a likely outcome. The lender will be required by its home tax authority to charge interest at arm's length rates, whereas New Zealand would apply its interest rate cap. In such a case, more disputes between tax authorities would result, most likely leading to additional mutual agreement procedures. Additional compliance costs would be inevitable, and it is not clear that the New Zealand Government would prevail.

An alternative approach would be for the US parent to provide a guarantee to the New Zealand subsidiary to reduce the cost of borrowing. In such circumstances, OECD guidance suggests that a guarantee fee should be paid to the parent company. The fact that OECD endorses the payment (and therefore deduction) of a guarantee fee reflects the fact that an interest rate anchored to the parent's cost of funds is not arm's length.

Agreement in principle to change in treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities for consistency with the test employed in other jurisdictions, but we note that this would result in a material increase in gearing levels for some members, particularly those with large provisions, trade creditors or deferred tax liabilities.

The ability to use net current assets should be retained.

The Government is correct to highlight that current thin capitalisation rules work well given their aim of ensuring that excessive interest deductions are not used to shelter New Zealand sourced profits.

Most multinationals operating in New Zealand have relatively modest debt levels. EY's recent research (cited above) supports that conclusion. Members have seen no evidence to suggest that the

majority of multinationals are sheltering New Zealand sourced profits using excessive levels of related-party debt.

Members do however note that the changes to the treatment of non-debt liabilities will significantly increase calculated gearing levels, particularly for members with large provisions, trade creditors or deferred tax liabilities. That makes it more important for calculations to give fair value to assets and for the definition of non-debt liabilities to be well designed.

The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.

The non-debt liabilities definition is based on the Australian definition, and – as in Australia - deferred tax should be excluded.

For some of our members, deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS. Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

Compliance costs will increase

The ability for taxpayers to carry out a thin capitalisation calculation once each year should be retained.

We note that the changes to the thin capitalisation test will increase the burden of compliance for multinational taxpayers. An example is the proposal that only quarterly or daily calculations should be acceptable for the purposes of the measurement date of the thin capitalisation test. Absent any evidence that multinationals are abusing the annual method, we see no reason to change the rules. To do so would add a compliance burden to the majority in order to address a problem which has not been seen by our members and must be very rare in practice.

Existing financing arrangements should be grandparented

We are concerned that companies will not have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time. This logic applies equally to all multinationals.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return. It would not be reasonable to expect borrowers to refinance based on a proposal in a discussion document which may be subject to significant amendment prior to enactment.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature.

6. Transfer pricing

Support for alignment with OECD Guidelines and appropriate Australian rules

We agree that New Zealand's transfer pricing regime should be aligned to international best practice. Consistency with the regimes applied in other jurisdictions will also help avoid the incidence of double taxation.

In our members' experience, since reform in 2012, the Australian transfer pricing rules have led to additional disputes between multinationals, the Australian Tax Office and overseas tax administrations. We expect that the proposals to reform the transfer pricing regime in New Zealand will result in a similar increase in the number of disputes, and we note the compliance costs associated with this.

Limited risk distributors commonly reflect commercial substance

The LRD model is one commonly used throughout the world. It is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken in New Zealand happens at the end of the supply chain and is often relatively low in terms of the value-adding functions contributing to the system profits of the enterprise.

The implication of the discussion document seems to be that, in most cases, LRDs structures lack commercial reality and most risks are controlled by the New Zealand entity. More often, for these businesses the global marketing strategy is conducted offshore and tight control maintained over marketing spend, inventory levels and major business decisions of the LRD. The New Zealand subsidiary will have substantially smaller resources at its disposal and will often undertake market activation activity rather than development.

This point has previously been accepted by Inland Revenue. In one recent example, John Nash, Manager (International Revenue Strategy) was commented:

"In terms of the way we tax, is you tax the value-add. I wish it wasn't like this. But you can only tax what gets added in New Zealand and we're right at the end of the value chain. Unfortunately, that's the state of the industry in New Zealand; it's not necessarily a reflection of profit-shifting."

Applying the arm's length standard

We note that, in assessing the transfer prices employed by taxpayers and determining whether adjustment is appropriate, the Commissioner has the advantage of hindsight which our members will not have when entering into the transaction. Shifting the burden of proof onto our members in relation to transfer pricing matters could be problematic, if we are later required to show that the arrangement was arm's length based on an outcome we could not have predicted. The Commissioner should take care not to impose unrealistic requirements on members in relation to genuine, but underperforming, business ventures.

Opposition to time bar extension

Tax positions assessed in the year ended 31 March 2013 are now time barred, but under the proposals could be reopened for a further three years. Members consider that this is inappropriate; any changes should be prospective in their application only.

Some members have invested considerable time and money in negotiating APAs with Inland Revenue. It is possible that legislative changes could override the effect of these APAs, effectively penalising taxpayers whose intention it was to be proactive in managing transfer pricing risk in a constructive way with Inland Revenue. The agreements should be honoured given their lower risk to the New Zealand revenue base and the inequity that would be created should taxpayers need to renegotiate such agreements.

We consider that any need for the extension of the time bar is limited should the proposal to shift the burden of proof to the taxpayer be adopted. This is because, should the taxpayer have the burden of proof, the Commissioner's concerns in relation to accessing relevant information are mitigated by an ability to more readily adjust transfer pricing outcomes where the taxpayer is non-compliant.

In addition, the Government will already have access to improved information flows through country-by-country reporting and automatic exchanges of information between Revenue Authorities.

Further, although the proposed extension of the time bar is limited to transfer pricing matters, there are complications associated with an adjustment for the interactions between transfer pricing and other matters, including income tax and withholding tax. If an extension of the transfer pricing time

bar is pursued, it should be clear what delimits a "transfer pricing matter" from another, to avoid the Commissioner pursuing something as a transfer pricing matter to "get around" a more restrictive time bar for another regime.

Evidence and documentation requirements

Given that the revised transfer pricing rules would place a burden of proof on our members to show that their transfer pricing is arm's length, it is important that it is clear to members what is required. In other jurisdictions around the world, the legislation is notably more prescriptive and sets out clearly what is required in documentation.

In New Zealand, Inland Revenue does not habitually set out its requirements in a formal way which creates difficulty for multinationals attempting to assess their documentation requirements (in many cases, by centralised tax functions overseas). Inland Revenue should set out unambiguously what is required of taxpayers. Mere endorsement of the OECD Guidelines does not assist taxpayers with little understanding of the particular risks to the New Zealand revenue base to which Inland Revenue's concerns more specifically relate.

7. Administrative measures

Penalties for not providing information

Penalties for failure to provide transfer pricing information should not be imposed on New Zealand business officers and/or directors.

It is proposed that changes be made to allow a person to be convicted of an offence if they fail to provide information held by an associated offshore group member. The New Zealand subsidiary of a multinational tends to be small in the context of the group's global operations. Our members note that officers and/or directors of New Zealand subsidiaries will often have little or no ability to compel offshore parents to provide information. We submit that it is not appropriate to impose penalties on New Zealand officers and/or directors for this reason.

Non-cooperation

Obtaining information can be difficult for a small subsidiary of a multinational.

We note that some of the factors proposed in the discussion document that lead to a finding that a taxpayer is "non-cooperative" are wide in scope (e.g. failure to respond to Inland Revenue correspondence). We submit that there should be some acknowledgement that on occasion delays in

obtaining information are not driven by an unwillingness to provide information, but rather by the difficulties in obtaining information from within large organisations generally.

Collection of information

Additional information gathering powers are unlikely to be effective and should not proceed.

We submit that Inland Revenue is likely to have sufficient ability to collect information from large multinationals under existing rules by virtue of country-by-country reporting and automatic exchange of information.

As noted previously, the introduction of specific provisions that enable Inland Revenue to directly request information or documents offshore may be unlikely to result in Inland Revenue receiving information in a timelier manner, on the basis that delays in obtaining information tend to be attributable to the internal workings of large organisations rather than deliberate non-cooperation. This is particularly so in light of the size of New Zealand relative to other jurisdictions that multinationals operate in, rather than a result of unwillingness by large multinationals to provide information. Country-by-country reporting and automatic exchange of information arguably provides Inland Revenue with a better method of collecting information than the specific provisions proposed in the discussion documents.

Early payment of disputed tax

Payment of tax in dispute at an earlier stage of the disputes process is not appropriate. Large multinationals are unlikely to default on the tax due, with use of money interest being an inadequate form of recompense for taxpayers.

Taxpayers generally do not enter into a dispute with Inland Revenue to delay the payment of tax. Rather, there is a genuine dispute over the tax position taken and amount of tax payable. In this respect, large multinationals in dispute with Inland Revenue should not be treated differently from any other New Zealand taxpayer.

The use of money interest and late payment penalties regime should be a strong enough disincentive not to prolong a dispute. The power of use of money interest is further evidenced by taxpayers using tax pooling services to mitigate its effects.

8. Conclusion

AmCham believes that New Zealand's tax laws are currently among the best in the world. New Zealand has a strong tax treaty network, a proven and effective thin capitalisation regime and a well-established transfer pricing regime.

AmCham supports a coordinated global response to BEPS, and endorses the work of the G20 and OECD. To the extent that the New Zealand Government proposes implementing the OECD's recommendations, our members broadly support the Government's intentions. However, where the proposals extend beyond implementing OECD recommendations, we do not see the Government has sufficient justification to take unilateral action.

A coordinated global approach will lead to better outcomes for tax authorities and for taxpayers.

We understand these submissions may be the subject of a request under the Official Information Act 1982 and consent to their release.

Yours sincerely

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#024

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30 April 2017

BEPS – Interest Limitation Rules
C/- Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath,

Submission
BEPS – Strengthening our interest limitation rules: A Government discussion document

Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch (Westpac collectively) welcome the opportunity to submit on the Government discussion document "BEPS – Strengthening our interest limitation rules" (the Discussion Document) published in March 2017. Westpac appreciates both the opportunity to provide feedback on the Discussion Document and to continue to engage with officials in relation to the proposals.

Westpac is a member of the New Zealand Bankers Association (NZBA) and the Corporate Taxpayers Group (CTG) and supports the submissions provided by those bodies on behalf of their members. The following comments are intended to supplement the feedback provided by NZBA and CTG.

In summary we do not support the proposal outlined in the Discussion Document to limit the deductible interest rate on related party loans from a non-resident to a New Zealand borrower. We submit that at a minimum New Zealand banking groups should be excluded from the ambit of the proposals and that the rules should be refined so that they target the specific cases of abuse (as outlined in paragraph 1.4 of the Discussion Document, where it is acknowledged that only a minority engages in the behaviour these proposals are intended to target).

We have limited our comments to the proposals contained in Chapter 3 on the basis that most of the changes outlined in the Discussion Document do not apply to New Zealand banking groups given that the industry is already subject to a special thin capitalization regime.

We note the following in support of our submission:

Regulatory framework

The Discussion Document outlines the policy rationale for the proposals in paragraphs 3.3 to 3.14. In essence we understand that Inland Revenue Department (IRD) are concerned that the transfer pricing rules are ineffective to combat, in a related party scenario, tax aggressive behaviour and specifically the use of excessive and uncommercial interest rates for related party loans. The statements contained in these sections do not apply to Westpac and New Zealand banks more generally. This is due largely to the regulatory and commercial environment in which registered banks operate.

One of the primary tasks of the Reserve Bank of New Zealand (RBNZ) is to monitor and supervise registered banks in order to maintain the health and stability of the financial system. Under the RBNZ rules[1] a bank can only be registered where it meets criteria relating to its financial position, governance and ability to carry on business in a prudent manner (hereinafter referred to as conditions of registration) all of which preclude aggressive and uncommercial behavior including in respect of related party loan structuring.

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[1] Further details of the extensive banking regulatory environment (based on Basel III principles) under which New Zealand registered banks operate are provided in the NZBA submission.

More specifically, a combination of the capital adequacy and liquidity frameworks in which New Zealand banks operate mean that the perceived behaviour used as justification for the proposals just do not exist in a banking context.

First, within the capital adequacy framework (BS2A and BS2B) a registered bank must maintain certain levels of regulatory capital. Currently the RBNZ prescribed minimum capital ratios for Common Equity Tier 1 (CET1), Tier 1 and Total Capital, are 7.0%, 8.5% and 10.5% respectively. CET1 must be made up of ordinary share capital and retained earnings (i.e. no debt element whatsoever). Ordinary share capital is universally accepted to be the most expensive form of funding, for any entity, predominately due to the risk of return given that ordinary shares rank last in the case of company liquidation. In respect of the other elements that can make up a banking groups regulatory capital (Additional Tier 1 and Tier 2 capital), while they can be debt in legal form, they must contain features in respect of subordination, tenor, discretion over interest payments and loss absorbency that mean from a regulatory perspective these instruments are more akin to share capital than ordinary debt funding. In such instruments, the interest rate will reflect the restricted rights of holders of an Additional Tier 1 or Tier 2 instrument and level of subordination in terms of ranking in liquidation. This is simply how the market operates from a commercial perspective, reflecting the balance between risk and return.

Secondly, the RBNZ's Liquidity Policy (BS13) impacts on the type and source of funding a New Zealand banking group can hold. The policy provides for a cap on any single party providing funding and for the purposes of the limits, related parties of a registered bank are treated as a single provider of that funding. BS13 therefore means that from a tax perspective the risk of excessive related party lending does not exist. Additionally, BS13 prescribes RBNZ disclosure requirements in respect of liquidity risk and liquidity risk management.

From both a capital efficiency and profitability perspective (noting that the weighted average cost of funding is a key driver of a banks net interest margin), it is in the New Zealand's banks interest to optimize its funding costs through diversification of funding sources. The features of regulatory capital and limits on related party funding create a natural bias for a bank to leverage its parent's ability to raise regulatory capital rather than "standard" unsubordinated debt not least because generally the offshore parent bank can raise regulatory capital at a much cheaper rate than a New Zealand bank could (we also refer you to the NZBA submission that outlines further reasons for the bias to utilising related party to meet a New Zealand banks regulatory capital requirements).

The New Zealand regulatory banking framework recognizes:

- the need for a bank to have an appropriate level of capital to cover its risks and maintain the health and stability of the financial system,
- that capital is expensive and that requiring too much capital will limit credit supply, and
- that different sources of capital are available which can reduce the overall cost of capital and thus allows (within prescribed limits) for different types of capital instruments to be issued.

Assuming rational economic behaviour, it can be expected that a New Zealand bank will optimize its capital structure to include Additional Tier 1 and Tier 2 capital. Further, that in sourcing such capital a New Zealand bank would look to leverage its offshore parents' market position. This reflects that the non-resident parent bank has deeper and greater access to capital markets than a New Zealand bank. This potentially reduces the cost of capital for a New Zealand bank. Accordingly, it is often the case that Additional Tier 1 and Tier 2 capital will be sourced from or through a related party entity (subject to BS13 liquidity requirements).

The Discussion Document proposes that the deductible interest rate be limited to the parent company's credit rating (plus a margin) as applied to unsubordinated debt with a maximum term of 5 years. If you accept the proposition that there is a preference for a bank to seek regulatory capital funding (which is heavily subordinated with an absolute minimum term of 5 years) from its offshore parent it then follows that the cap proposed will deny at least in part the interest expense on that instrument.

We do not agree with the comment at paragraph 3.17 that such an approach will ensure that the interest rate on related-party loans will therefore be roughly in line with the interest rate a borrower would agree with a third-party lender. As noted above, the features of regulatory capital required to be held by banks to the extent that this takes the form of debt (as Additional Tier 1 or Tier 2 capital) rather than pure equity mean that commercially such instruments will be priced accordingly. Any investor (whether it is a third party or related party) would seek a commensurate return to the level of risk inherent in such instruments.

The sourcing and allocation of funds of a bank are driven by factors that are not applicable to commercial and industrial companies. If the cap on related party interest rates proceeds as proposed, in our view it

will inevitably increase the cost of capital in New Zealand (either as a result of the double taxation that will result from using Additional Tier 1 or Tier 2 instruments, or through such instruments no longer being viable and more expensive ordinary equity being required in their place to meet the RBNZ prescribed capital adequacy levels).

We understand that the concern that officials are seeking to address is the artificial weakening of a New Zealand entity's balance sheet that allows related party debt to be priced at a higher (contrived) rate. This issue does not and cannot exist given the regulatory banking framework (as the amount of related party funding is limited by BS13[2]) and the very nature of its business (being credit intermediation). Any artificial weakening of a bank's balance sheet would be value decretive as it would result in third party funders charging a higher cost. Therefore the perceived risk simply does not exist within the banking sector as the combination of regulatory constraints, market demands and the nature of business constraints mean that it would be counter-productive to the essence of a banking business to artificially weaken the balance sheet of a deposit taking entity.

As such, we do not believe that there is any basis for a general interest limitation rule to apply to the banking industry.

New Zealand banks are net deposit takers

The Discussion Document assumes that a group of companies will incur net third party interest expense, which may then be allocated around the various group entities. The allocation of group interest expense is meaningless in a banking context because banks are margin lenders and derive net interest income from a wide variety of external funding sources and markets. This point was specifically noted in the OECD's original discussion draft on BEPS Action 4:

> *"....taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore, a rule which caps net interest expense will have no direct impact on a bank or insurance company ..." (para 205)*

Further a New Zealand banks' ability to attract funding in both retail and wholesale markets is based on the strength of its balance sheet. Thus there is no rationale for a bank to weaken its balance sheet through excessive leverage. The premise, on which this proposal rests, of an artificially weakened balance sheet, is the antithesis of what occurs in the context of a bank which funds from the market.

The OECD has repeatedly acknowledged that there is a low risk in the banking sector in relation to excessive leverage. In this regard we refer you to the commentary in Chapter III of the OECD Report "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" published in December 2016, and in particular the comments at paragraph 510 in relation to a general limitation rule such as that proposed in the discussion document:

> *"In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a general risk at this point in time and so it is anticipated, in the majority of cases, countries will find this risk to be low. Excessive leverage in entities in a group with a banking or insurance company has been identified to be a greater risk. However because of differences in regulatory and tax rules between countries, there may be countries where this risk is adequately addressed. Where this is the case, there is no expectation that a country should apply a general interest limitation rule aimed at dealing with a risk that does not exist or is already addressed."*

As highlighted in this document and the NZBA's submission, there is no risk of excessive leverage in New Zealand banking groups due to the extensive and ongoing regulation of banks in Australia and New Zealand by the Australian Prudential Regulation Authority (APRA) and RBNZ.

Double Taxation

Westpac is concerned that in the case of bank debt, interest limitation represents a significant and unwarranted departure from accepted transfer pricing principles that apply across tax jurisdictions world-wide. Any rule that overrides the arm's length standard would give rise to a number of undesirable and

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[2] For example as at 30 September 2016, total liabilities for the Westpac New Zealand Banking Group was NZD $86.3 billion, of which NZD $4.6 billion was related party. (See https://www.westpac.co.nz/assets/Who-we-are/About-Westpac-NZ/Disclosure-statements/Westpac-Banking-Corporation-Sept-2016.pdf)

arbitrary outcomes including double taxation. At a minimum this proposal is contrary to the transfer pricing principles espoused in New Zealand's extensive tax treaty network.

In this regard, we are concerned that it will not be possible to achieve mutual arbitration outcomes under a double tax agreement where, by way of example the IRD and Australian Taxation Office (ATO) disagree about the appropriate level of interest rate on related party loans.

Referring to the comments above in relation to the required nature of the type of arrangements that qualify as regulatory capital the interest rate cap will create artificial outcomes. The Australian parent bank will need to apply an arms length rate otherwise the ATO will reconstruct the terms of the arrangement to achieve this. Those terms will reflect market pricing for heavily subordinated, long term and in the case of Additional Tier 1, perpetual debt that will exceed the rate proposed by IRD. The tension between transfer pricing norms and the proposed interest limitation will lead not just to double taxation but also to greater uncertainty in pricing, more complexity in undertaking cross border transactions and additional compliance costs.

Conclusion

In summary we consider that the current tax and regulatory environment in which the New Zealand banking industry operates is more than sufficient to safeguard against the risk of excessive interest deductions by New Zealand banks. The extent of this regulation makes it unfeasible for Westpac New Zealand Limited and Westpac Banking Corporation NZ Branch to manipulate related party loans in the manner that IRD are seeking to address. In point of fact, this has been acknowledged by OECD where in its Discussion Draft on BEPS Action 4 it was noted:

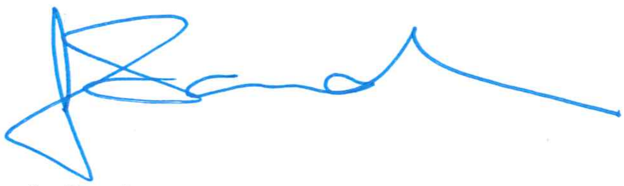
> *"existing regulatory requirements [might] act as an effective general interest limitation rule, and prevent excessive leverage in group entities..." (para 212)*

We believe that the proposal, if it were to proceed, will inevitably increase the cost of capital in New Zealand. Having regard to the conditions of registration, New Zealand banks do not have the options available to corporates in other industries to structure out of related party loans (and conversely these same rules prevent New Zealand banks from manipulating the terms of such loans). Tax rules should not interfere with normal banking commercial practice or run counter to the imperatives of banking regulation and the health and stability of the New Zealand financial system.

As such we consider the application of a general interest limitation rule to Westpac and the banking industry more generally as an unnecessary overreach.

As noted above we welcome the opportunity to discuss with you in more detail the comments raised in this submission.

Yours faithfully
Westpac New Zealand Limited



Jo Sawden
Head of Tax

Corporate Taxpayers Group

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C T G

28 April 2017

BEPS – Strengthening our interest limitation rules
C-/ Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Cath

BEPS – STRENGTHENING OUR INTEREST LIMITATION RULES

The Corporate Taxpayers Group ("the Group") is writing to submit on the Government Discussion Document "BEPS – Strengthening our interest limitation rules" (the "discussion document"). The Group is appreciative of the opportunity to submit on this discussion document and looks forward to discussing the proposals further with officials. The Group also appreciates having had the opportunity to talk to Officials[1] about the discussion document and those discussions have informed some of the comments in this submission.

We provide a summary of our submission below. Further detail is included in the following Appendices:

- Appendix One: General comments
- Appendix Two: Limiting the interest rate on related-party loans
- Appendix Three: Treatment of non-debt liabilities
- Appendix Four: Other matters
  Appendix Five: Comparison of New Zealand and Australian thin capitalisation rules

Summary of our submission

The key points in our submission are:

- The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector adequate time to fully work through the issues which may arise from these proposals.

- The Group supports some proposals in the discussion document, such as amendments for infrastructure projects, but does not support many of the other proposals as we

[1] Workshop held with Officials on 18 April 2017. Officials in attendance: Carmel Peters, Matt Benge, Casey Plunket, Hamish Slack, Phoebe Sparrow, Steve Mack and Matt Gan.

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consider them not fit for purpose. They are, in our view, not in New Zealand's overall best interests as they increase uncertainty, increase compliance costs and reduce our competitiveness (especially given our relatively high corporate tax rate and other major tax reforms happening elsewhere in the world).

- The Group believes these proposals are a case of too much, too soon. Many proposals across the two BEPS discussion documents are targeted at the same behaviour. The Group believes a more cautious approach is required. Let one or two proposals bed down before changing our entire international tax landscape. We note the Minister's own comments that "It is important that these BEPS measures do not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation."[2] Such radical change can only give rise to significant uncertainty.

- The Group agrees with the comment at 1.3 of the discussion document that "we consider that our rules are serving us well. The rules are well understood and set clear and largely predictable limits on the amount of deductible debt allowable in New Zealand."

- The Group agrees with the comment at 2.1 of the discussion document that "New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment. FDI can also bring ancillary benefits to New Zealand, such as new technology and management practices." The Group agrees that the Government should remain committed to ensuring New Zealand remains an attractive place for non-residents to invest. It is our view that the proposals have the narrow focus of tax revenue enhancement and there is little evidence in the issues paper that the broader economic issues have been considered in any meaningful way. There must be a broader enquiry into the economic effect that these proposals would likely have before they proceed any further.

- While the Group does not support wholesale adoption of all OECD recommendations, the Group submits that the direction of reform in New Zealand should be consistent with the BEPS recommendations made by the OECD. By introducing an interest rate cap, which has not been recommended by the OECD, we are departing from the international norm of the arm's length principle. The OECD continues to support the arm's length principle.

- The discussion document states it does not consider whether New Zealand should change to an EBITDA-based interest rule, while asking submitters to provide a preference between an EBITDA-based rule or the proposals contained in the discussion document. The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred versus making some limited amendments to the existing thin capitalisation rules. That is, enhancements to the existing rules should be trialled before determining whether an EBITDA test is more appropriate.

- The Group appreciates two of the aims of the interest rate cap, being to provide certainty and reduce compliance costs. However, the fact that no other countries are contemplating an interest rate cap and it is inconsistent with OECD recommendations, transfer pricing and double tax agreements ("DTAs") means the Group cannot support this proposal.

- A fundamental principle applied in international taxation is that transactions need to be undertaken on an arm's length basis. The Group agrees with the principle mentioned at 3.17 of the discussion document that New Zealand should ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would

[2] http://taxpolicy.ird.govt.nz/news/2017-03-03-beps-consultation-documents-released#speech

agree with a third party. This is a rate set in accordance with the arm's length principle. In the Group's view, limiting the interest deduction available in New Zealand to the parent's credit rating plus a margin will result in over taxation in New Zealand and double taxation overall when the foreign taxing jurisdiction demands a higher interest rate be charged to reflect the arm's length differential in credit ratings.

- The potential for double taxation will also occur because the interest rate is to be set by reference to senior unsecured debt issued by the parent. If commercially the loan into New Zealand is required to be other than at senior unsecured (for example for regulatory purposes), then the interest rate charged must reflect that economic reality and cannot simply be set to the rate of senior unsecured debt issued by the parent.

- The only instance where the Group sees merit in the interest rate cap is if it were used as a safe harbour. Taxpayers who can support a different interest rate (having regard to the transfer pricing requirements) should continue to be able to deduct interest at that rate.

- The Group does not agree with a five year maximum loan term. Commercial loans may commonly be up to ten years or more. Corporates will ensure their debt is structured with a variety of term lengths to minimise re-financing risk.

- The Group does not support moving to a net asset approach. There are a number of liabilities which are either not real liabilities (e.g. deferred tax on buildings) or which are more appropriately characterised as equity (e.g. redeemable preference shares).

- The Group supports the key principle that third party funding provided to bankruptcy remote infrastructure projects should be excluded from thin capitalisation regardless of whether the entity in question is controlled by a single non-resident or multiple non-residents.

- The Group supports having a de minimis rule for inbound thin capitalisation rules, but does not consider the de minimis should be restricted to only entities with no related party debt (which includes third party debt guaranteed by a related party). The related party debt restriction is likely to make the de minimis very limited in application.

- The Group supports the proposed grandparenting of existing financing arrangements for non-residents acting together. This grandparenting is good practice. However, the Group fails to understand the rationale of denying any interest on owner-linked debt where the 60 percent threshold is breached. Any denial needs to be proportional to the breach.

- The Group does not support the proposal to only allow taxpayers to use asset values reported in financial statements. The discussion document does not provide any rationale for the change to the valuation options contained in section FE 16 of the Income Tax Act 2007. It is noted that subsection FE 16(2) requires all of the asset valuation options to accord with generally accepted accounting practice, with the exception of two particular types of assets (trading stock and finance leases).

- The Group does not support removing the ability of taxpayers to measure asset and liability amounts on the last day of the income year.

- The Group submits that more consideration should be given to aligning some of the positive features of the New Zealand and Australian thin capitalisation regimes.

- The Group does not support most application dates proposed. Taxpayers have legitimately entered into arrangements on the basis of the tax laws in place and the legitimate expectation that those rules would continue. To change tax laws too quickly without sufficient grandparenting or lead in time will damage New Zealand's reputation, which may have a chilling effect in relation to future foreign direct investment and current asset values.

We look forward to discussing this submission further with you.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ Bank New Zealand Limited
5. ASB Bank Limited
6. Auckland International Airport Limited
7. Bank of New Zealand Limited
8. Chorus Limited
9. Contact Energy Limited
10. Downer New Zealand Limited
11. Fisher & Paykel Healthcare Limited
12. Fletcher Building Limited
13. Fonterra Cooperative Group Limited
14. Genesis Energy Limited
15. IAG New Zealand Limited
16. Infratil Limited
17. Lion Pty Limited
18. Meridian Energy Limited
19. Methanex New Zealand Limited
20. New Zealand Post Limited
21. New Zealand Racing Board
22. New Zealand Steel Limited
23. New Zealand Superannuation Fund
24. Opus International Consultants Limited
25. Origin Energy New Zealand Limited
26. Pacific Aluminium (New Zealand) Limited
27. Powerco Limited
28. Shell New Zealand (2011) Limited
29. SKYCITY Entertainment Group Limited
30. Sky Network Television Limited
31. Spark New Zealand Limited
32. Summerset Group Holdings Limited
33. Suncorp New Zealand
34. T & G Global Limited
35. The Todd Corporation Limited
36. Vodafone New Zealand Limited
37. Watercare Services Limited
38. Westpac New Zealand Limited
39. Z Energy Limited
40. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely,

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE: DETAILED SUBMISSION POINTS – GENERAL COMMENTS

1. General comments

Timeframes

1.1 The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector adequate time to fully work through the issues which may arise from these proposals.

1.2 The timing of release of all three BEPS related documents (3 March 2017) was unfortunate as many taxpayers are heavily committed to tax compliance and financial reporting activities during the months of March and April.

1.3 Given the breadth of issues being consulted on and the potential overlap of proposals between this discussion document and *BEPS – Transfer pricing and permanent establishment avoidance* the Group believes that a further round of consultation should take place later in 2017, prior to any changes being included in a tax bill.

Wider economic concerns

1.4 The Group's overarching concern is that the proposals contained in the issues paper have the potential to significantly impact the flow of capital to New Zealand, the willingness of non-residents to establish business in New Zealand and may cause harm to New Zealand's reputation as place where it is easy to do business.

1.5 The Group agrees with the comment at 2.1 of the discussion document that "New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment. FDI can also bring ancillary benefits to New Zealand, such as new technology and management practices." The Group agrees that the Government should remain committed to ensuring New Zealand remains an attractive place for non-residents to invest. The Group is concerned that the proposals in this discussion document will actively discourage foreign direct investment, resulting in a detrimental effect on the wider economy.

1.6 Overall New Zealand is a net capital importer, and these changes penalise offshore investors with strong credit ratings. The Group notes that for organisations such as pension fund investors, the true cost of capital is the statutory obligation to provide a minimum rate of return to its stakeholders. The Group notes a larger tax burden on inbound investment will likely increase the cost of capital because non-residents will require a higher rate of return from their New Zealand investments to ensure they are no worse off due to the additional tax levied. We note the following comments from the 2001 McLeod Tax Review, which considered the taxation of inbound investment:

> *"Non-resident lenders will be willing to invest funds in New Zealand only if they receive a return after paying New Zealand tax that is at least equal to that they could achieve elsewhere.*
>
> *As a result, higher New Zealand taxes will mean non-residents will require a higher before-tax rate of return from their New Zealand investments. By driving up the required return from investment, New Zealand taxes raise the cost of capital to New Zealand businesses and lower the amount of investment.*

> *In these circumstances, the tax on the non-resident is not borne by the non-resident, but is passed on to other factors of production (for example, to labour in the form of lower wages). That is, the economic incidence of the tax falls on New Zealanders, rather than the non-resident on whom the tax is legally imposed."*[3]

1.7 The proposals may also affect the flow of foreign capital to New Zealand. Foreign investors have the choice of where to invest and what markets to establish in. New Zealand is a small market. We need to ensure that our tax rules do not discourage foreign direct investment into New Zealand or multinational corporations using New Zealand as a base for their operations. If foreign companies no longer invest into New Zealand because the tax rules are too onerous in comparison to the size of the potential market, this will have a direct impact on the New Zealand economy through reduced GDP (growth) and employment levels. There is an obvious negative effect of a loss of revenue for New Zealand (including GST) and a reduction of consumer choice.

1.8 In the Group's view, many of the proposed changes negatively influence the attractiveness of New Zealand as an investment destination. New Zealand's tax system plays a critical role in our competitive position with our trading partners and competitors. The unilateral, unprincipled interest rate cap proposals undermine our competitive position.

1.9 The economic costs of unduly restricting the deductibility of the interest costs of New Zealand enterprises are potentially high. It will often be the case that a New Zealand venture with potentially high returns but high risk (such as biotechnology or IT) will need considerable overseas capital to grow, especially if high profits are only available by scaling the venture up globally. An ideal foreign investor is often a globally diversified fund (or group of funds) with a high credit rating that is able to undertake risk because of its diversified portfolio. The extent of capital injection required means the fund(s) may need to take a controlling equity interest. However, the foreign fund will still want New Zealand investors to keep a substantial equity involvement in order to align incentives. This limits the amount of capital that can be raised by way of equity.

1.10 The remaining funding (capital) is therefore required to be provided by way of debt. Financial institutions are unlikely to provide such debt funding because of the risk – or if they did so only at very high interest rates. Outside of financial institutions, the most obvious source of debt funding is the foreign fund(s). The fund(s) ownership interest means that it has an in-depth and up to date knowledge of the New Zealand investment so that it has a better view than an external financier of the actual debt risk involved.

1.11 Obviously, however, from a purely commercial perspective the fund(s) will want an interest rate on this related party debt that reflects its actual commercial risk – which is the risk associated with the New Zealand firm, which will be considerably higher than the fund(s) cost of debt based on the fund(s) high credit rating. If interest on such related party debt is restricted to the interest rate that the fund(s) could borrow on standard terms (defined as the fund(s)'s credit rating – where it has a credit rating - for senior unsecured debt on standard terms plus a margin), a material part of the commercial interest cost of the New Zealand entity would become non-deductible. Arguably, in this scenario the interest rate cap would be lower than a rate charged by an unrelated third party. Applying the proposals in the discussion document in this way would amount to introducing a tax penalty on high risk/ high growth New

[3] McLeod Tax Review, 2001, page 76.

Zealand ventures with global potential. That seems clearly contrary to the government's economic growth strategy.

1.12 Tax changes that have the potential to increase the cost of capital and / or restrict the flow of foreign capital should not be made lightly, and full consideration must be given to the economic impact of these proposals. It is our view that the proposals have the narrow focus of tax revenue enhancement and there is little evidence in the issues paper that the broader economic issues have been considered in any meaningful way. There must be a broader enquiry into the economic effect that these proposals would likely have before they proceed any further.

1.13 The Group agrees with the comment at 1.3 of the discussion document that "we consider that our current rules are serving us well. The rules are well understood and set clear and largely predictable limits on the amount of deductible debt allowable in New Zealand." In the Group's view, only selected changes are required to be made to the rules and some of the changes proposed in this discussion document are in excess of what is actually necessary. The specific proposals are discussed later in our submission.

Certainty, compliance costs and competitiveness

1.14 The Group believes that a good tax system should be built around three principles in particular: certainty; compliance costs; and competitiveness. As noted further below, it is important that international competitiveness is maintained, especially in relation to Australia, as higher costs of doing business in New Zealand flow through to less investment, fewer jobs and lower wealth. New Zealand's tax system plays a critical role in the attractiveness of New Zealand for both inbound and outbound investment. For New Zealand to remain competitive it is important to recognise that taxes are a significant cost to businesses and any costs imposed must have a significant corresponding benefit.

1.15 It is also important that New Zealand doesn't rush into new rules before other jurisdictions, and also that any measures are proportional to the problem. As the Commissioner noted in the 2016 Multinational Compliance Focus Document: "*In the last few years Inland Revenue has placed an increased level of scrutiny on the tax practices of multinationals. I'm pleased we have found nearly all businesses open and willing to engage with us positively, and proud to contribute to New Zealand.*"[4] This is supported by recent research carried out in New Zealand which indicated that current debt levels of non-resident owned businesses are conservative and effective tax rates are close to the statutory rate of 28 percent[5].

1.16 It is important to consider the changes occurring / that have occurred in Australia and the potential impact (whether negative or positive) of those changes. As New Zealand's largest inbound investor, Australia's approach to this issue is very important. The Australian Government has stated that it will not be making any further changes to its existing thin capitalisation rules. If New Zealand proceeds with the proposals in the discussion document, our competitiveness with Australia will be significantly undermined.

1.17 The Group believes these proposals are a case of too much, too soon. Many proposals across the two BEPS discussion documents are targeted at the same behaviour. The

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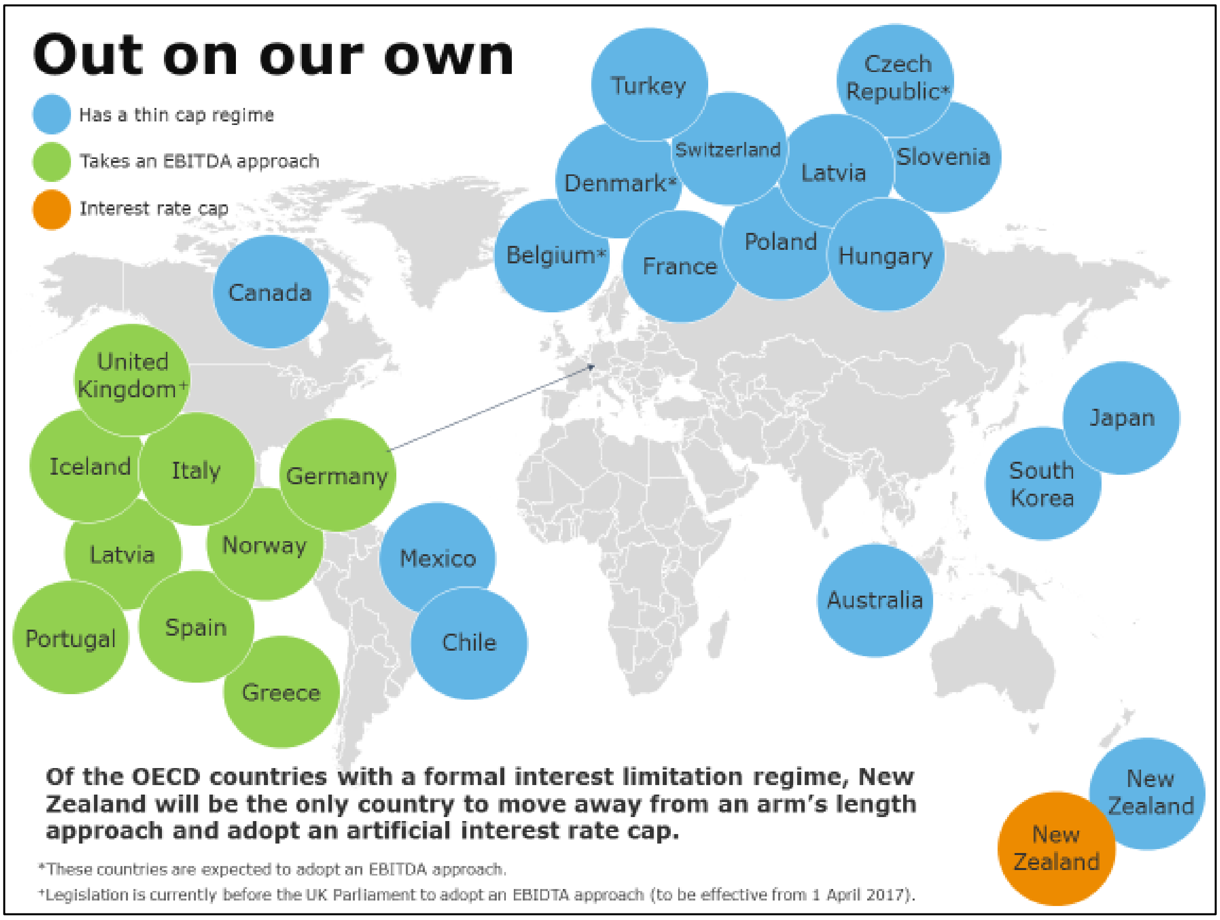
[4] http://www.ird.govt.nz/resources/6/2/62414b82-6ab8-4017-b04d-cc5d950cab47/compliance-focus-2016.pdf, Page 1

[5] Do corporates pay their "fair Share" of tax in New Zealand?: Effective tax rates in corporate New Zealand – domestic corporates versus foreign multinationals. EY, March 2017.

Group believes a more cautious approach is required. New Zealand should let one or two proposals bed down before changing our entire international tax landscape. We note the Minister's own comments that "It is important that these BEPS measures do not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation."[6] Such radical change can only give rise to significant uncertainty.

1.18 An interest rate cap puts New Zealand out of step with the OECD and the rest of the world. This proposal could result in a replication of what happened with New Zealand's previous controlled foreign company rules: "We had the best international tax system in the world if only the world had followed. Unfortunately we did a kind of reverse Star Trek: we went where no man followed." – Michael Cullen, 2007



Purpose of the thin capitalisation rules

1.19 The policy objective of inbound thin capitalisation rules was stated in the original 1995 Discussion Document (*International Tax – A discussion document*) to be to "limit the ability of non-resident investors to artificially reduce their net New Zealand-sourced income by allocating excessive interest costs to New Zealand". The policy aim was further stated as being "to accurately determine interest expense properly attributable to New Zealand without interfering with normal commercial behaviour, at minimal compliance cost, within the self-assessment system".

1.20 In effect, the thin capitalisation regime is an anti-abuse rule. Dividends are non-deductible (so that the New Zealand tax rate on the equity investment by a non-

[6] http://taxpolicy.ird.govt.nz/news/2017-03-03-beps-consultation-documents-released#speech

resident in a New Zealand company is the company tax rate of 28% plus NRWT on dividends, if any). Interest is deductible so that the New Zealand tax rate on debt finance is limited to the NRWT (or AIL) on interest. The policy concern that underlies thin capitalisation rules is that debt is substituted for equity so that what would in the absence of tax be taxed as an equity return (28% plus any NRWT) is instead taxed at the much lower rates on interest. At the extreme, a non-resident could invest $1 of equity and repatriate all profits as interest paying minimum New Zealand tax on the investment.

1.21 As the 1995 discussion document made clear, concerns with protecting the New Zealand tax base need to be balanced by having a tax system that is attractive to foreign investors given New Zealand dependence on investment from abroad to generate economic growth. Thin capitalisation rules have therefore always been seen, from a policy perspective, as targeting situations where it could reasonably be concluded that investment was being undertaken by debt that was in substance equity or would have been by way of equity if based on normal commercial considerations.

1.22 When New Zealand introduced its thin capitalisation and transfer pricing rules in 1995, maximum debt levels were set under thin capitalisation and this explicitly excluded the operation of transfer pricing. This was for a number of reasons:

- The policy concern was to set a maximum gearing ratio rather than the price or interest rate.

- The policy was explicitly to include in maximum debt levels, debt from unrelated parties if a New Zealand enterprise was foreign controlled. Transfer pricing was seen as restricted to limiting only related party debt.

- Transfer pricing was relatively undeveloped internationally at that time and New Zealand had little background in operating such rules so that transfer pricing alone was seen as inadequate to protect the tax base especially given the limited experience of Inland Revenue in operating transfer pricing rules. It is understood there was a concern that since transfer pricing focused on price (the arm's length price) it might not limit the quantum of debt, and even if it did so, Inland Revenue might not have the technical expertise to manage transfer pricing rules that also covered the level of debt.

1.23 Further, since New Zealand's thin capitalisation rules did not override our double tax agreements ("DTAs"), where (principally by way of Article 24 – non-discrimination) DTAs required interest to be deductible if such interest met the arm's length transfer pricing test, New Zealand accepted that the arm's length test overruled the thin capitalisation rules.

1.24 Transfer pricing is now well developed internationally and New Zealand taxpayers and Inland Revenue have developed considerable expertise in operating transfer pricing rules. For example, the OECD is now clear that Article 9 of the Model Convention (the transfer pricing article) "is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital."[7] The rationale is that transfer pricing rules aim to establish a level of profits from a transaction that corresponds to the profits that would have resulted from an arm's length transaction

[7] 2014 Commentary pages 183-184

and to achieve this, the level of debt as well as the interest rate needs to be on an arm's length basis.

Transfer Pricing / Arm's Length Tests

1.25 At our workshop with Officials on 18 April 2017, it was suggested by Officials that the OECD has **explicitly** rejected transfer pricing as a tool to manage the pricing and quantity of debt. Extracts from the final BEPS report on interest limitations were cited as evidence of this conclusion. The relevant paragraphs are copied below[8]:

Use of interest and payments economically equivalent to interest for base erosion and profit shifting

11. Rules currently applied by countries fall into six broad groups, with some countries using a combined approach that includes more than one type of rule:

1. Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.

2. Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction.

3. Rules which disallow a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made.

4. Rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets.

5. Rules which limit the level of interest expense or debt in an entity with reference to the group's overall position.

6. Targeted anti-avoidance rules which disallow interest expense on specific transactions.

12. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately after arrangements are entered into, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules (e.g. in pricing the interest income and expense of an entity before applying other interest limitation rules). In particular, countries have experience of groups structuring intragroup debt with equity-like features to justify interest payments significantly in excess of those the group actually incurs on its third party debt. Additionally, an arm's length test does not prevent an entity from claiming a deduction for interest expense which is used to fund investments in non-taxable assets or income streams, which is a base erosion risk specifically mentioned as a concern in the BEPS action plan (OECD, 2013).

[8] Limited Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report.

13. Withholding taxes are primarily used to allocate taxing rights to a source country, but by imposing tax on cross-border payments they may also reduce the benefit to groups from base erosion and profit shifting transactions. Withholding tax has the advantage of being a relatively mechanical tool which is easy to apply and administer. However, unless withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. In fact, in some cases withholding taxes can drive base erosion and profit shifting behaviour, where groups enter into structured arrangements to avoid imposition of tax or general additional tax benefits (such as multiple entities claiming credit with respect to tax withheld). Where withholding tax is applied, double taxation can be addressed by giving credit in the country where the payment is received, although the effectiveness of this is reduced if credit is only given up to the amount of tax on net income. This can impose a significant cost on groups not engaged in base erosion and profit shifting, if an entity suffers withholding tax on its gross interest receipts, but is unable to claim a credit for this because its taxable income is reduced by interest expense. In practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. It would also be extremely difficult for European Union (EU) Member States to apply withholding taxes on interest payments made within the European Union due to the Interest and Royalty Directive.[5] In addition, there are broader policy reasons why some countries do not currently apply withholding tax to interest payments, which could make the introduction of new taxes difficult. Taken together, these factors mean that in many situations withholding taxes would not be a suitable tool for completely tackling the base erosion and profit shifting risks which are the subject of this report. However, countries may still continue to apply withholding tax alongside the best practice.

14. Rules which disallow a percentage of all interest paid by an entity in effect increase the cost of all debt finance above any de minimis threshold. Therefore, entities with a relatively low leverage will be subject to the same proportionate disallowance as similar entities with very high levels of debt. This approach is likely to be more effective in reducing the general tax preference for debt over equity, than in targeting base erosion and profit shifting involving interest.

15. For the reason set out above, the rules in groups 1 to 3, on their own, do not address all the aims of Action 4 set out in the BEPS Action Plan (OECD, 2013). As such, they are not considered to be best practices in tackling base erosion and profit shifting involving interest and payments economically equivalent to interest if they are not strengthened with other interest limitation rules. However, these rules may still have a role to play within a country's tax system alongside a best practice approach, either in supporting those rules or in meeting other tax policy goals. Therefore, after introducing the best practice approach, a country may also continue to apply an arm's length test, withholding tax on interest, or rules to disallow a percentage of an entity's total interest expense, so long as these do not reduce the effectiveness of the best practice in tackling base erosion and profit shifting.

1.26 The Group strongly rejects the summation by Officials that the above paragraphs mean that OECD has rejected transfer pricing as a tool to manage the pricing and quantity of debt. The above extracts from the final report note the OECD's conclusion that transfer pricing rules ***"on their own"*** do not address all of the action 4 aims and therefore ***on their own*** are not best practice. These paragraphs do not suggest (as Officials have asserted) that transfer pricing principles have no role to play in addressing profit shifting and the pricing and quantity of debt. For countries that have introduced an EBITDA rule, this simply operates as a backstop to interest deductions.

That is, related party loans must first be priced on an arm's length basis which is then deductible up to a certain proportion of EBITDA. Clearly a jurisdiction would not be happy with an above arms-length rate being charged (and treated as deductible) simply because the entity was within the relevant EBITDA threshold.

1.27 The Group does not rely solely on transfer pricing to manage the amount of deductible interest in New Zealand. We have an existing thin capitalisation regime, which the OECD did not list as an ineffective option to manage the deductibility of interest from a base erosion perspective.

1.28 The Group also notes that OECD is expected to release transfer pricing guidance on financial transactions during 2017[9]. This work stream is one of the follow ups to the BEPS project and illustrates that OECD still sees transfer pricing as playing a role in debt pricing. This also demonstrates that New Zealand's work in this area is premature. We should be waiting for the draft guidance to be released, rather than stepping out on our own.

Interaction with our double tax agreements

1.29 Article 9 of the Model Convention provides that where an enterprise has related party transactions not on arm's length terms these can be adjusted by tax authorities to produce a profit that would have accrued to the enterprise if transactions were on an arm's length basis and that profit can be made liable to tax by a jurisdiction. As discussed in the OECD's 1986 "Report on Thin Capitalisation" and in the Commentary to Article 9, there have been differences of views as to the scope of this article. In particular as to whether Article 9:

- Allows a jurisdiction to adjust profits to those arising on an arm's length basis (in which case New Zealand would not be restricted to taxing profits in excess of those that would be calculated on an arm's length basis); or

- Whether the article prohibits countries from calculating and taxing profits in excess of those that would be calculated on an arm's length basis (in which case DTAs based on the Convention would overrule any attempt by New Zealand to impose a deductible interest rate cap not in conformity with the arm's length principle.

1.30 The OECD's conclusion was that the latter of the above alternatives is the correct way to interpret DTAs. This is reflected in the following statement on page 184 of the 2014 Commentary Update:

> *"the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and this principle should be followed in applying existing tax treaties."*

New Zealand has not lodged any observations on this aspect of the Commentary.

1.31 Article 24(3) of the Model Convention states that a permanent establishment of a non-resident cannot be less favourably taxed than a New Zealand company carrying on the same activities. Article 24(4) states that interest paid by a New Zealand company to a non-resident shall be deductible under the same conditions as if it had been paid to a resident of New Zealand. An exception applies if the transfer pricing article (Article 9) applies. It is generally accepted that these provisions override thin

[9] http://mnetax.com/oecd-officials-discuss-latest-international-tax-initiatives-20306

capitalisation / restrictions on interest deductibility (similar to those proposed in the Discussion Document) if such rules are inconsistent with the results under transfer pricing. For example, the OECD Commentary on Article 24 states that the article:

> *"does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible [with transfer pricing rules]. However, if such treatment results from rules which are no compatible with [transfer pricing rules] and which only apply to non-resident [lenders] (to the exclusion of resident [lenders]), then such treatment is prohibited." (2014 Commentary, page 367).*

1.32 The Discussion Document argues that its proposed cap on interest deductibility where the lender is non-resident would be consistent with our DTAs on a number of bases. The Group disagrees with Officials' analysis:

- As noted above, the OECD Commentary states that thin capitalisation rules are consistent with the arm's length principle to the extent the profit that results would have accrued in an arm's length situation (discussed at para 3.57 of the discussion document). In the simple parent/subsidiary example where both operate similar businesses it may be that the parent's cost of funds could be used to determine the subsidiaries cost of funds, but this does not apply to other arrangements where the Discussion Document approach seems to produce a result not in accordance with transfer pricing and the arm's length principle. If the discussion document did produce an arm's length approach it would then be more logical and clearer for New Zealand to adopt the arm's length approach to related party interest rates.

- The discussion document suggests that the interest rate cap would be a domestic anti-avoidance provision and because as a general rule there will be no conflict between domestic anti-avoidance rules and a DTA the proposed interest rate cap it consistent with our DTAs (para 3.59). This seems to suggest that a country can label any provision of domestic law "anti avoidance" on the basis it is expected to raise revenue that might not otherwise be raised and then ignore its DTAs. The end result would be that DTAs would be ineffective in limiting double taxation or protecting taxpayers. The OECD Commentary warns that *"it should not be lightly assumed that a taxpayer is entering into . . . abusive transactions"* (2014 Commentary page 63). Anti abuse provisions are consistent with DTAs only to the extent that they counter transactions that are contrary the object and purpose of the DTA provisions. The object and purpose of the OECD Model Convention is clearly to apply the arm's length principle to cross-border related party transactions. A domestic law provision that prevented the application of the arm's length principle would be contrary to the object and purpose of DTAs and such a provision cannot be justified on the basis that it does the opposite.

- The discussion document argues that given the OECD has recommended countries adopt an interest limitation rule the interest rate cap is consistent with our DTA obligations regardless of the fact the OCED recommends an EBITDA based rule. Clearly the Discussion Document approach is not consistent with international practice given the interest rate cap is unique in the world. As paragraph 3.38 of the Discussion Document states: "We are not aware of other countries imposing a similar interest rate cap in relation to their thin capitalisation rules". Whether or not an interest rate cap is seen as equivalent to what OECD recommends is not determinative of whether or not the approach would be overridden by a DTA. In any case the OECD EBITDA approach explicitly does not limit interest deductions to situations where the lender is non-resident. Instead the OECD recommends that the EBITDA approach apply at a minimum

to all entities that are part of any multinational group but the OECD also suggests it could usefully apply to all entities including stand-alone companies with purely domestic operations (OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – 2016 Update, page 37). The inconsistency with the provisions of the DTA thus does not arise with the OECD proposal. They do, however, arise with the Discussion Document proposal.

1.33 As such, the Group does not agree that the proposed interest rate cap is consistent with New Zealand's double tax agreements. It is submitted that given the arm's length test is our primary rule for limiting the deductibility of related party cross border interest rates under our DTAs it should be our primary provision under domestic law.

APPENDIX TWO: DETAILED SUBMISSION POINTS – LIMITING THE INTEREST RATE ON RELATED-PARTY LOANS

Disclaimer: no comments on practicalities or mechanics of the proposals is intended to be read as an endorsement of the proposals unless explicitly stated.

2. Limiting the interest rate on related-party loans

Summary

2.1 The Group does not support this proposal in its current form. The Group believes that it is unprincipled to abandon the arm's length pricing principle with respect to debt pricing. Such unilateral action is inconsistent with our treaty obligations and the work undertaken by OECD, and in many scenarios, may give rise to double taxation. If this type of measure is pursued, the Group submits that there should not be an *absolute* cap on the deductible rate of interest. Instead, the cap should provide a safe-harbour, with taxpayers being able to pay (and deduct) a higher arms-length price, if the taxpayer can substantiate the debt pricing by applying existing transfer pricing rules.

2.2 In our workshop Officials indicated that they believed Australia would be happy to accept the interest rate cap amount as the taxable interest income in Australia. The Group submits some form of binding undertaking should be received from Australia before this type of assumption is factored into decision making on this issue. The Group considers it unlikely that other jurisdictions will accept that an interest rate cap imposed by New Zealand represents an arm's length price, and that double taxation is the more likely outcome.

2.3 There is an inconsistency between the reforms being introduced and the scale of the problem to be addressed. The discussion document notes that only a small number of taxpayers are abusing the system. At paragraph 1.4 it is noted that "[w]hile the majority of firms subject to the thin capitalisation rules have taken conservative debt positions, there is a minority that engages in more aggressive tax practices." In the Group's view, the proposed interest rate cap is disproportionate to the mischief it is seeking to address and unfairly punishes taxpayers who comply with arm's length pricing. The Group would like to see Inland Revenue provide some evidence or workings to demonstrate the scale of the perceived problem. Given this rule will apply to all related party lending in the Group's view, Inland Revenue needs to demonstrate there is a significant problem before an interest rate cap that is inconsistent with OECD recommendations is pursued.

2.4 The 5 year term assumption is not valid for a number of reasons, which are outlined below.

2.5 In circumstances where you have two substantial shareholders, reliance on the majority shareholder's credit rating is inappropriate.

2.6 Many taxpayers do not have credit ratings, including large taxpayers such as members of the Group, and would be required to determine what the appropriate interest rate for the parent would be (as per paragraph 3.23). Taxpayers should not have to incur the costs of determining the appropriate interest rate when they otherwise would not be required to do so. This illustrates that the interest rate cap method may not be as easy to apply in practice as Officials suggest.

2.7 The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred over making some amendments to the existing thin capitalisation rules (but

not necessarily to the extent of the proposals contained in the discussion document) as a first step.

Proposal

2.8 Paragraph 3.17 of the discussion document summarises the proposal in respect of the interest rate on related party loans as follows:

> *We propose amending the thin capitalisation rules to limit the deductible interest rate on related-party loans from a non-resident to a New Zealand borrower. We consider that such a cap is the best approach to ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would agree to with a third-party lender. We consider that such a rule would also reduce or eliminate costly disputes over what an appropriate interest rate is under standard transfer pricing.*

2.9 The proposed interest rate cap would be set at the interest rate the borrower's ultimate parent could borrow at on standard terms, plus a margin. The cap would not apply to third party debt.

2.10 As noted earlier in our submission, the OECD are releasing guidance in 2017 in relation to financial transactions transfer pricing. The Group submits that if the interest rate cap proposal goes ahead, no decisions should be made in relation to margin until this guidance has been released and can be considered fully.

Concerns with an absolute cap

2.11 We understand that Officials are concerned that despite New Zealand's existing thin capitalisation regime, profit shifting still occurs through the rate rather than quantum of related party debt. While the thin capitalisation rules limit the amount of debt, they do not regulate the quality of debt. The group appreciates the reasons why the proposal appears an attractive option to address this issue. At first glance, it is relatively simplistic and easy for taxpayers to apply, and more straightforward for Inland Revenue to audit. However, we strongly believe that the benefits of this proposal are significantly outweighed by the disadvantages associated with an absolute interest cap. The proposal is a blunt and unprincipled tool that will harm New Zealand's reputation as an inbound investment destination.

2.12 The Group accepts that the policy issue that is the objective of thin capitalisation rules is the level of interest deductions. This is determined by not only the level of debt (constrained by current thin capitalisation rules) but also the price of debt (the interest rate). We accept that in the simple case of a New Zealand firm 100% owned by a non-resident parent, increasing the risk associated with parent lending may be used to justify a higher interest rate but does not alter the parent's overall investment risk. We can understand the argument why in such a scenario high interest rates can be viewed as substituting non-deductible dividends for deductible interest. However, we consider that any policy response should be targeted at situations where there is this close substitutability of interest for dividends and should be reasonable in that context.

2.13 The Group considers that the proposed interest rate cap is inconsistent with the arm's length principle. It is a fundamental concept of international taxation that transactions between related parties need to be undertaken on an arm's length basis. A lending jurisdiction will, after reflecting on the true economic risks, require an arm's length margin (not one artificially set by notching down the parent's credit rating as is proposed). Furthermore, any analysis must remain focussed on the actual transaction being priced, not some hypothetical scenario where the NZ borrower is

put in the shoes of its overseas parent who has scale, geographical diversification and access to funding markets that its subsidiary does not have.

2.14 While the OCED has commented that transfer pricing may not be wholly effective to manage base erosion and profit shifting in the context of debt pricing, it has also not completely dispensed with transfer pricing / the arm's length principle for debt (as discussed earlier in our submission).

2.15 In our workshop Officials indicated that they believed Australia would be happy to accept the interest rate cap amount as the taxable interest income in Australia. The Group submits some form of binding undertaking should be received from Australia before this assumption is factored into decision making on this issue. The Group considers it unlikely that other jurisdictions will accept that an interest rate cap imposed by New Zealand represents an arm's length price and that double taxation is more likely to occur.

2.16 The underlying assumptions in the proposed test appear to be that the multinational parent will borrow from third parties using its better parent rating and then on-lend the funds to its subsidiaries, which appears to be coupled with an implicit duty on the multinational parent to support its subsidiaries. In the Group's view, this is an incorrect starting assumption for the majority of multinationals. For example, the Group notes that institutional investors (such as pension funds) will shield themselves from standalone investment risk so as to limit risks to the fund's overall exposure, as part of the "enterprise risk management policy".

2.17 The proposal also appears to implicitly assume that a third party commercial lender would factor in the creditworthiness of the parent entity to determine the appropriate interest rate when lending to a subsidiary. The Group submits that an assumption of implicit parental support is not valid. A rational commercial lender would never rely on implicit support and would require a guarantee to be signed if support of the parent was to be relied on. This undermines the credibility of what is proposed in the discussion document. It is a commercial reality that companies fail – limited liability exists for a reason. Implicit support "*is like a metaphorical invincible wallet. It is something investors believe exists and may be available to provide financial support if the right circumstances are present, but few investors are foolish enough to believe that it is equivalent to a guarantee*".[10] Further any parental support, either implicit or explicit can only be one factor amongst many which the commercial lender would consider.

2.18 The underlying assumption in the proposals is that subsidiaries / associates largely carry the same risk as the parent or materially the same risk as the parent. This is flawed. This is particularly so where the activities of the subsidiary differ in nature from those of the parent or the wider group. Debt and equity investors will consider (amongst other factors):

- The country (or countries) in which the company operates. Investors will typically seek exposure to particular countries and industries. Therefore, a parent borrower with international exposure is likely to attract a different investor base compared to a subsidiary with activities in one single country.

- The industry in which the company operates. Similarly, different industries present different risk profiles, which will appeal to different types of investors.

- The size and tenor or the loan/investment.

[10] General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563, at para 287

Parent and subsidiaries can therefore represent vastly different investment profiles to a lender/investor and using the parent's credit rating will often not be the most appropriate comparable to start with in order to assess a subsidiary's commercial interest rate. Likewise a multinational collective investment vehicle with a diversified portfolio would have a credit rating which would be materially different from the credit rating of a subsidiary holding a speculative petroleum mining permit in New Zealand. In such a case, it cannot realistically be argued that the correct market interest rate of the New Zealand entity is the interest rate the foreign lender would be required to pay on its borrowings. It cannot realistically be argued that the foreign entity's debt is substitutable for equity. Finally it cannot realistically be argued that in provided related party debt, the risks assumed by each investor remain the same as the investment equity finance.

2.19 The interest rate charged on debt is a matter of pricing. For all other related party transactions the arm's length principle is applied to determine the appropriate price. The Group submits that to disregard this approach would be unprincipled. The proposed approach in the discussion document is not used anywhere else in the world. If New Zealand pursues this approach, double taxation may arise. Where the price determined applying the arm's 's length principle is greater than the interest rate cap set, the deduction in New Zealand would be limited to the capped amount, however the corresponding overseas jurisdiction will almost certainly look to receive and tax the higher arm's 's length amount.

2.20 We understand that Inland Revenue is concerned that it does not have the tools available to address profit shifting through debt that is uncommercial. The Group does not agree with this sentiment. Inland Revenue is able, under current rules, to investigate, dispute and reassess taxpayers who are not complying with transfer pricing principles. Transactions which seek to artificially drive down the quality of the New Zealand balance sheet so as to drive up funding costs are ultimately ineffective if Inland Revenue uses the tools it already has. As such, an interest rate cap is not also needed to address this issue.

2.21 Beyond the broader fundamental concerns the Group has with the proposal, there are also issues in the detail of what is proposed, which we briefly comment on:

- The 5 year term assumption is not valid for a number of reasons, including:

    a) It is inconsistent with Treasury Management principles. "Fund early, fund long" is an important principle of debt maturity profile management which means companies should seek to refinance maturing debt early and try to secure the longest debt maturity possible for core debt funding. This is even more important today given the uncertain economic outlook.
    b) Funding may be required for a specific project or purpose such that a 5 year term is not appropriate.
    c) Where a mix of related and non-related party debt is used, the term of the related party debt will often need to be longer than that for the bank debt as the bank does not want shareholder debt repaid prior.
    d) Businesses will seek a range of funding options and may even take on debt for terms of 10 – 15 years as is often present in the USPP market.
    e) Many corporates have capital structures with staggered terms / maturities to minimise the risk associated with refinancing. As such, both short terms and long term debt can be arm's length.

- In circumstances where there are two substantial shareholders, reliance on the majority shareholder's credit rating is inappropriate. For example in a scenario

where you have two shareholders with 51% and 49% shareholdings respectively, reliance on the 51% shareholder's credit rating is inappropriate, particularly if that rating differs substantially from the 49% shareholder's credit rating.

- Many taxpayers do not have credit ratings, including large taxpayers such as members of the Group. As such, all this proposal will achieve is to shift the debate from being "what is the appropriate rate on the inbound debt into New Zealand" to what is the appropriate risk rating / credit rate of the relevant parent entity. The Group does not believe the proposal will be as simplistic in its application as the discussion document seems to suggest, and a credit rating of an overseas parent company is not something that can be easily determined by a New Zealand subsidiary if one does not already exist.

- How are appropriate interest rates to be determined? Based on the application of New Zealand interest rates or interest rates prevailing in the parent company jurisdiction? For example, World Bank data from 2016[11] indicates that on average a 5% interest rate applies in New Zealand, but a 1% rate applies in Japan and a 52% rate applies in Brazil. Would borrowing by a subsidiary of a Japanese company be capped based on the rate of interest applying to the parent's credit rating as if they were borrowing in New Zealand (i.e. 5%) or in Japan (i.e. 1%)? If the parent company was in Brazil, would the interest rate be capped based on 52% or 5%?

- There is not enough clarity on when the interest rate cap would be set. It should be confirmed that this is set at the outset and does not change in the event that the parent company credit rating changes.

- The discussion document does not comment on what occurs when a taxpayer still must pay an arm's length rate of interest. If interest deductions are denied, will NRWT be able to be calculated based only on the amount of deductible interest?

EBITDA approach

2.22 The discussion document states it does not consider whether New Zealand should change to an EBITDA-based interest rule, and asks submitters to provide a preference between an EBITDA-based rule and the proposals contained in the discussion document.

2.23 The objective of the OECD's EBITDA approach is to reduce what the OECD views as a tax preference for debt over equity. In the main we view that as a tax penalty on equity resulting largely from the classical double taxation of company income. The EBITDA-based rule can be seen as trying to level the international playing field by trying to imposing a tax penalty on an element of interest. However, these considerations are not relevant in the New Zealand environment where debt and equity have more equal tax treatment as a result of imputation. Instead the New Zealand focus should be purely on ensuring that our thin capitalisation rules do not allow New Zealand corporate income to be extracted as low-taxed interest in a manner contrary to the intent of our policy settings. We submit that this is best achieved through transfer pricing methodology with safe harbours to reduce compliance and administrative costs where the tax base risk is low.

2.24 The Group considers that an EBITDA-based rule is too blunt and therefore is not preferred over making some amendments to the existing thin capitalisation rules (but

[11] http://data.worldbank.org/indicator/FR.INR.LEND?view=chart

not to the extent of proposals contained in the discussion document). For example, an EBITDA-based rule may handicap groups that are heavily capitalised and have tangible fixed assets with long depreciation periods, as well unfavourably affecting industries with volatile earnings (for example primary production which is cyclical effected by adverse movements in commodity pricing or foreign exchange exposure).

2.25 Further, the Group considers that the complexity of the rules required to ensure that an EBITDA test is applied appropriately would make such a rule unnecessarily complicated for the issues at hand (given the existing and proposed tools that the Commissioner has to deal with excessive interest costs). An EBITDA test can be manipulated through aggressive accounting policies relating to revenue and expense recognition, timing of sales and asset write-downs and the related depreciation schedule adjustments. In the Group's view, an EBITDA approach would be susceptible to a range of accrual accounting adjustments (i.e. the valuation of debtors and variations due to financial hedging). Further it would be difficult to come up with and agree on particular ratios, as part of the EBITDA test, that would be suitable for a wide range of industries (and specific ratios for each industry would lead to uncertainty around which industry a taxpayer belongs to).

2.26 The Group notes that an EBITDA test will also be inappropriate depending on where a business is in its business life-cycle. For example a petroleum miner undertaking decommissioning will logically have negative EBITDA.

2.27 We note that in an article to be shortly published in the New Zealand Law Review[12], leading tax academic Professor Craig Elliffe evaluates the merits of an EBITDA test in the New Zealand context and concludes that there is no case for change from the existing debt to asset thin capitalisation regime. We suggest Officials contact Professor Elliffe for a copy of the paper to consider the points raised.

2.28 Notwithstanding the above, the Group does see a role for an EBITDA test in the context of determining an arm's length interest rate and a commercial balance sheet. An EBITDA ratio could be one of the factors considered by Inland Revenue when applying the arm's length test. However, the Group does not support an absolute cap on interest deductions based on an EBITDA test.

2.29 The Group notes there is some merit in considering an EBITDA test as an additional <u>optional</u> safe-harbour test. Some taxpayers are unable to reflect the true value of their business in their balance sheet (particularly if there are intangible assets or low historic costs which cannot be valued up) when those assets are valuable and generate income streams. An EBITDA test has merit in these circumstances. We discuss these issues further in our submission under the heading *Asset Valuations.*

Safe harbour[13]

2.30 The Group understands Officials' concerns that it is difficult to obtain sufficient comfort that profit shifting through debt pricing is not occurring. In this regard, the Group sees merit in the cap being used as a safe harbour only. Taxpayers who do not wish to undertake full transfer pricing analysis to determine an arm's length price would be free to apply a rate that meets the interest rate "cap" (or in this case safe harbour). However, a taxpayer should be able to exceed this safe harbour where

[12] Interest Deductibility: Evaluating the Advantage of Earnings Stripping Regimes in Prevent Thin Capitalisation, Craig Elliffe.
[13] A further alternative could be that the interest rate cap only applies for arrangements with non-DTA countries, with arm's length pricing preserved for lending from countries with which New Zealand has a DTA. We refer again to Craig Elliffe's paper in this regard.

(under transfer pricing rules) the interest rate reflects the commercial reality of the lending risks. I.e. where taxpayers can support a different interest rate having regard to the transfer pricing requirements, they should be able to use that interest rate.

2.31 The key advantage of this approach is that it would mean that Inland Revenue could focus its compliance / audit resources on those taxpayers who wish to use a rate over the safe-harbour and it would still allow taxpayers to use a greater interest rate where it is appropriate to do so on an arm's length analysis.

2.32 The Group believes that as part of this, Inland Revenue could issue guidance on the factors to be considered when determining the arm's length rate and whether a taxpayer's balance sheet would be regarded as commercial. One key indicator in this regard could be an EBITDA safe-harbour such that if interest deductions fall within the safe-harbour this would be an indication that the taxpayer has a commercial level of debt set at an arm's length rate. The Group would be happy to consult with Officials on these guidelines.

APPENDIX THREE: DETAILED SUBMISSION POINTS – TREATMENT OF NON-DEBT LIABILITIES

Disclaimer: no comments on practicalities or mechanics of the proposals is intended to be read as an endorsement of the proposals unless explicitly stated.

3. Treatment of non-debt liabilities

Summary

3.1 The Group does not support these proposals. The perceived issue is not one which has any connection to BEPS.

Examples

3.2 The Group has concerns with the examples contained within Chapter 4 of the discussion document, their relevance and their accuracy. In particular, examples 4 and 5 are premised on an example where a mining company pays out all cash earnings (before factoring in a decommissioning provision) and places itself in a negative equity position. In reality it would not be possible as the mining company cannot pay the level of dividend the example is suggesting because it would not satisfy the solvency test. These examples are used as justification for changing the rules because the outcome in these examples is different from an example where a taxpayer does not have a provision. However they don't reflect the commercial reality that the transactions in the example could not actually occur.

International comparisons

3.3 The discussion document refers to a <u>recent</u> study[14] by the IMF looking at 28 countries with thin capitalisation rules. This study is used to conclude that apart from New Zealand, all countries base their rules off either net assets or equity. The Group wishes to note that the study quoted, while published in 2014, involved the researchers constructing a data set of thin capitalisation rules in 54 countries for the period 1982 – 2004. The Group submits that there is limited relevance to a study analysing tax rules which are over 13 years old. The Group wishes to point out that there are other aspects of thin capitalisation rules which are important to consider, including the fact that many jurisdictions only apply the rules to related-party debt.

Commercial approach to lending

3.4 The Group disagrees with the sentiment that net assets are of more relevance to third party commercial lenders than gross assets. First and foremost banks are interested in the future cash-flows of a business. Thereafter the bank will be interested in the realisation value of assets that it can take first ranking security as a backstop should cash-flow forecasts prove incorrect. Banks will generally rank ahead of unsecured creditors and therefore non-debt liabilities relating to creditors will generally be disregarded unless they relate to an asset for which the bank cannot take a priority ranking security over.

3.5 The Group is concerned that this proposal will operate to dampen the exact economic activity that New Zealand should be trying to encourage, particularly in the context of outbound thin capitalisation. During periods of rapid growth, taxpayers will require access to substantial funds to support that growth and in particular fund large

[14] Blouin, J, Huizinga, H, Laeven, L, and Nicodeme, G, *Thin Capitalisation Rules and Multinational Firm Capital Structure*, IMF Working Paper WP/14/12.

increases in working capital. Often it is not an option for taxpayers to raise additional share capital and debt cannot be pushed down to the foreign jurisdiction. Banks are increasingly willing to provide additional types of finance such as invoice and inventory finance to help fund this growth, on the strength of future increases in cash flows, meaning that the bank may be lending at higher levels than it otherwise would. Taxpayers in this situation will be severely disadvantaged and may need to consider slowing the pursuit of growth opportunities. This would be detrimental to the New Zealand economy.

3.6 The Group is also concerned that this proposal will have a significant impact on the cost of capital for New Zealand exporters. Notwithstanding the increased threshold of 75%, the commercial reality is that often debt cannot be pushed down into the foreign subsidiary and borrowing must occur at the New Zealand parent level.

Exclusions

3.7 In terms of what non-debt liabilities should be captured in the thin capitalisation calculation we make the following comments:

- To the extent that liabilities have not been used to fund the taxpayer's balance sheet they should not be considered a "non-debt liability" and should not be factored into the thin capitalisation calculation. The obvious example is derivative instruments that are designated as a hedge. Fair value movements in these instruments may give rise to significant volatility in a taxpayer's balance sheet – some form of "expected value" adjustment may assist with volatility.

- The Group notes that cashflow hedges may relate to future items which are not yet included in the balance sheet.

- Interest free loans from shareholders (which are proposed to be excluded from "non-debt liabilities") should encompassed shareholder current accounts and trade receivables from shareholders.

- Deferred tax liabilities should also be excluded from non-debt liabilities. Deferred tax does not reflect a true cash liability. In addition, a number of New Zealand corporates are carrying large deferred tax liabilities on their balance sheet due to the removal of depreciation on buildings. These amounts are not liabilities and would not be taken into account when raising funds from a third party lender. We note that the Australian thin capitalisation rules exclude both deferred tax assets and liabilities[15].

- Amounts that are more akin to equity should also be excluded from "non-debt liabilities. As noted, Officials are already proposing to exclude interest free loans from shareholders. The Group submits that arrangements like redeemable preference shares should also be excluded on the basis that they are more akin to equity.

Application date

3.8 As we expand on in Appendix Four, this proposal has the potential to materially move taxpayers' thin capitalisation calculations. There needs to be sufficient lead in time in terms of application date for these proposals to allow taxpayers sufficient time to restructure their balance sheet.

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[15] Income Tax Assessment Act 1997 – Section 820.682

APPENDIX FOUR: DETAILED SUBMISSION POINTS – OTHER MATTERS

Disclaimer: no comments on practicalities or mechanics of the proposals is intended to be read as an endorsement of the proposals unless explicitly stated.

4. Other matters

Summary

4.1 The Group supports a de-minimis rule, but as currently proposed, most taxpayers will not be able to qualify.

4.2 The Group supports changes for infrastructure projects and suggests some further refinements. The Group submits that this change should apply from the date of issue of the discussion document (3 March 2017).

4.3 Firms which are controlled by non-residents acting together should be able to deduct all arm's length debt where the debt is not proportional to shareholdings.

4.4 Alternative methods of valuing assets should continue to be available.

4.5 The Group does not support removing the ability to measure assets and liabilities at year-end for compliance cost reasons. The Group believes any mischief should be targeted through minor amendments to the existing valuation avoidance rule in section FE 11.

4.6 Thought should be given to aligning to some of the positive features included in the Australian thin capitalisation rules.

4.7 Any taxpayer unfavourable changes requiring taxpayers to potentially restructure their affairs should not apply until at least one year after the rules have been enacted. The most recently enacted taxation act was enacted on 30 March 2017, giving some taxpayers only 2 days before the commencement of their next income year; this is an inadequate amount of time.

De minimis

4.8 New Zealand currently has a thin capitalisation de-minimis of $1 million of interest deductions that applies in the context of the outbound thin capitalisation rules. It is proposed that this rule be extended to have application in the inbound thin cap rules.

4.9 The Group supports having a de minimis rule for inbound thin capitalisation rules. However, we do not agree with the restriction that none of the debt can be owner-linked debt. The Group considers that the proposed related party debt restriction is likely to make the de minimis very limited in application.

4.10 There are a number of reasons as to why it may be necessary to have owner-linked funding. For example, a newly established entity or operations may not be able to borrow in New Zealand so the non-resident parent may need to advance some funds to get the business started. Alternatively, it may be that the only way that the New Zealand entity is able to obtain borrowed funds is by the parent guaranteeing the debt. For interest deductions of this level there is little scope to undertake profit shifting activities and it would not be worth Inland Revenue's time to review these deductions. In this context it would be appropriate to extend the de-minimis to

inbound investment without the owner-linked debt restriction on compliance cost saving grounds.

4.11 The Group notes that in Australia a flat $2 million de minimis applies, regardless of whether any lending is related party.

Infrastructure projects

4.12 The Group supports the proposal for a taxpayer to be able to exceed the 60% safe harbour ratio for infrastructure projects. As the Group has previously discussed with Officials, the current thin capitalisation rules have constrained participation in the Public-Private Partnership (PPP) market. The rules need to change to ensure that the market is open to all participants and to ensure liquidity amongst investors. We comment below on some of the issues that need to be taken into account when designing this exception.

4.13 The proposals recognise that limited recourse third party debt is by definition an arm's length amount of debt. The Group agrees with this analysis. However, the current proposals are written in the context of an inbound thin capitalisation applying to a corporate vehicle. The same proposition should equally be applied to:

- Outbound thin capitalisation, such that third party debt for PPP assets does not negatively impact thin cap;

- Inbound thin capitalisation, regardless of whether the investment into New Zealand is structure through a company or LP structure. Specifically in an LP structure a limited partner should have access to the third party debt carve out. In this regard we note that in a limited partnership the thin capitalisation rules are applied at the limited partner level. This is a layer of complexity that Officials will need to work through. We are happy to discuss this issue in further detail with Officials if that would be of assistance.

4.14 In terms of the criteria outlined at paragraph 5.12 of the discussion document, we make the following comments:

- Bullet point one: Generally speaking the SPV which operates or owns the asset (legally) will be newly established for the project but investors into that may not. The restrictions on sale must relate to sale of the Crown assets held by the SPV and not to the investors staying invested in the project. This will require careful rules where a limited partnership is used for the SPV vehicle as the limited partners (i.e. the investors) are deemed for the purposes of other tax rules to be disposing of the underlying assets of the SPV LP. If the investors are not permitted to sell down / out of their investment this proposal would be rendered relatively useless. In many instances investors entering a PPP will not contemplate holding their investment for the life of the project. For example an investor may take an equity interest during the build phase and may sell out once the operating phase has commenced. Any sell down criteria also needs to have regard to the standard form PPP contract. In that contract all fixtures created during the D&C Phase are sold to the Crown at service commencement.

- Bullet point two: we comment further below on other scenarios the Group would like to see this proposal apply to outside of Government projects.

- Bullet point three: we comment further below in respect of related party debt.

- Bullet point four: if deductible debt is limited to third party debt this requirement is not necessary. A bank will not lend unless it considered that the assets can support that level of debt. In this regard we note that a bank would consider more than just the asset value and will also consider the cash flows of the project which drives how much an asset will be bank funded.

- Bullet point five: Reference to entity for the purposes of this criteria has to be the SPV not the equity/investor entities.

4.15 The Group does not agree that all related party debt should be non-deductible. In the Group's view equity investors should be able to take a debt interest in the project if it is at a level that a third party would bank. The tax system should not force investors to take bank debt and give debt margin away. There are legitimate reasons why an investor may want equity and debt returns. The Group submits that where related party debt is a substitute for third party debt (i.e. it would meet an arm's length debt test) it should remained deductible even with gearing levels above 60%.

4.16 At a minimum *non-proportionate* shareholder debt (for example where only one shareholder of a group of shareholders lends to the investment vehicle) should remain deductible. In this scenario the shareholder is effectively taking on the role of third party lender. In a scenario where there are two or more total shareholders there will be a natural pricing tension to ensure that a fair, arm's length price for debt is struck because, as you would expect, the remaining shareholders would not be willing to accept an uncommercial rate of debt. Shareholder debt in this situation should be considered akin to third party debt and should remain deductible (even above 60% gearing).

4.17 In respect of whether the proposal should apply more widely than Government projects, we see no reason to limit to the proposal PPP assets. There are other infrastructure assets able to be project financed at higher levels than 60% and the existing thin capitalisation rules are constraining funding by third parties. The Group submits that the proposal should also apply to other long life assets (say 10 year project) with third party limited recourse debt - for example a university accommodation project that contains both build and operate phases.

4.18 In terms of application date, the Group submits that taxpayers should have the option to apply the rules from the date of the discussion document. If Officials are concerned that the proposals are not sufficiently formed, in the alternative the Group submits that taxpayer should be able to apply the rules from the date of introduction of the relevant tax bill.

Non-residents acting together: related party debt

4.19 The discussion document outlines a proposal to amend the way the thin capitalisation rules apply to "non-resident owning bodies". If such a firm exceeds the 60% safe harbour, any owner-linked debt will be non-deductible.

4.20 The Group is supportive of this proposal in respect of *proportional* shareholder debt (for example shareholder debt that each shareholder holds in proportion to their shareholding). We agree there is scope for manipulation in that context. We also agree the amendment should apply prospectively. Investors have made investment decisions based on existing tax rules. Those investment decisions should not be undermined.

4.21 Notwithstanding the above, we do not agree with the proposal in respect of *non-proportionate* shareholder debt (for example where only one shareholder of a group of shareholders lends to the investment vehicle). In this scenario the shareholder is effectively taking on the role of third party lender. As we have discussed above, the tax rules should not penalise someone wanting to take on both the role of shareholder and lender. Given there will be two or more total shareholders there will be a natural pricing tension to ensure that a fair, arm's length price for debt is struck because, as you would expect, the remaining shareholders would not be willing to accept an uncommercial rate of debt. Shareholder debt in this situation should be considered akin to third party debt and should remain deductible (even above 60% gearing). Any arm's length debt should remain deductible above the 60% safe harbour because these investors will not have the benefit of a worldwide group test to reflect an appropriate industry debt level.

4.22 The Group notes that paragraph 5.20 of the discussion document states:

> "We propose to amend the rules for firms controlled by a group of non-residents acting together. If such a firm exceeds the 60 per cent safe harbour, any *owner-linked debt* will be non-deductible."

4.23 The Group submits that paragraph 5.20 contains an error and it is not intended at all owner-linked debt will be non-deductible, only the excess above the safe harbour.

Asset valuation

4.24 The Group does not support the proposal to only allow taxpayers to use asset values as reported in financial statements. The discussion document does not provide any evidence to suggest that the net current value method is being abused by taxpayers and as such, the Group considerers that there is insufficient rationale to justify the removal of the net current value method. It is noted that subsection FE 16(2) requires all of the asset valuation options to accord with generally accepted accounting practice, with the exception of two particular types of assets (trading stock, and finance leases).

4.25 This proposal puts New Zealand significantly out of step with the Australian thin capitalisation rules. The Group notes that in Australia, as a general rule, an entity must comply with the accounting standards when revaluing its assets for the purpose of calculating its thin capitalisation liability. However, an entity can choose to recognise / revalue an asset, including an intangible asset as long as it meets stringent requirements (noting that in Australia intangible assets, other than internally generated goodwill, can be recognised for the purposes of the thin capitalisation regime).

4.26 The Australian approach is significantly more generous than the existing New Zealand approach in that it allows you to bring into the asset net for thin capitalisation purposes assets which cannot be recognised for financial reporting purposes. The Group does not understand the justification for the Government seeking to restrict our asset valuation rules further.

4.27 The Australian rules include the requirement that if the revaluation is not included in the financial statements, the assets must be revalued by a person who is an expert in valuing such assets. This expert must be someone whose pecuniary and other interests could not reasonably be regarded as being capable of affecting the person's ability to give an unbiased opinion in relation to the revaluation.

4.28 There is a theme running through the discussion document of the Government wanting to align the thin capitalisation rules with what a third party lender would consider when it was considering how much to lend. The Group submits that the values expressed in the financial statements would have little bearing on the amount of debt lent. A bank would firstly consider the future cash flows of the organisation and then, as buttress to this, would consider what the assets of the organisation could be realised for. This value may or may not be reflected in the financial statements. A third party lender would also consider the cashflows that may be generated from off balance sheet assets. The point we are demonstrating is that the aspiration of aligning the thin capitalisation rules with what a third party lender would consider when it was considering how much to lend is not achieved through this proposal. Various third party banking experts can be made available to discuss this with Officials.

4.29 The discussion document expressed concern that asset valuations that are solely adopted for thin capitalisation purposes (and not in the financial statements) are not sufficiently robust because they are not reviewed by auditors and there is no repercussions for material misstatements. The Group submits that there are a number of options available to address this concern, including:

- Requiring the taxpayer to obtain an independent valuation to support the value adopted.
- Requiring taxpayers to disclose with their tax return whether they have used the net asset value method (this would allow Inland Revenue to appropriately target its compliance / audit resource).

4.30 In the Group's view, there are a range of reasons why revaluations may not be included on an organisation's balance sheet. As discussed with Officials at our workshop, there can be significant costs associated with annual revaluation of assets where the revaluation model is adopted for financial reporting. The Group submits that entities taking this conservative approach should not be penalised by the removal of the net current valuation method from the list of available valuation methods for thin capitalisation. As noted at our workshop, independent valuations would only be required in years in which it is necessary to deviate from the (lower) reported financial statement values for thin capitalisation. If Officials would like greater transparency around the use of the net current valuation method we suggest that Inland Revenue require disclosure with the income tax return if this method has been used. Then Inland Revenue can appropriately target its resource to these taxpayers if concerns remain around the use of this method.

4.31 At a minimum the Group submits that the net asset value method should be retained. The Group also submits that New Zealand should adopt the same position as Australia on the recognition / revaluation of assets and include intangibles in the asset calculation that are not able to be recognised for financial reporting purposes.

Measurement date for assets and liabilities

4.32 Currently, taxpayers are able to measure their assets and liabilities for thin capitalisation purposes either daily, quarterly or at year end. The Group does not support removing the ability of taxpayers to measure asset and liability amounts on the last day of the income year as requiring taxpayers to use one of the two other methods will create significant compliance costs. The proposal is not justified and there are other options available to address any perceived concern.

4.33 Throughout the discussion document there is a reliance placed on the integrity of audited IFRS accounting values. As noted above, Inland Revenue justifies the removal of the net asset valuation method on the grounds that reported financial statements are subject to a degree of scrutiny. To require taxpayers to use quarterly or daily measurement is completely inconsistent with this. None of the largest taxpayers in New Zealand will be preparing audited quarterly financial statements, let alone the smaller corporates.

4.34 The Group notes that as a compliance cost saving initiative many taxpayers are no longer required to prepare financial statements that comply with GAAP. To require quarterly calculations will compound the additional compliance costs that those firms already face.

4.35 IFRS accounting requires certain complex calculations including impairment testing, fair value and marked to market calculations. We assume Inland Revenue is not trying to suggest that taxpayers undertake this work on a quarterly basis. To require these to be done solely for tax purposes at points in the year when they are not already being done for financial reporting purposes imposes additional and unnecessary compliance costs. This issue is exacerbated by the inclusion of non-debt liabilities in the thin capitalisation calculation.

4.36 In this discussion document no evidence is offered to suggest that taxpayers are currently taking advantage of the year-end valuation method by ensuring that debt is paid down / capitalised before balance date. The Group submits that any mischief is likely to be immaterial given at most it would be a one year deferral of the thin capitalisation rules applying. If there are truly material instances of this occurring the Group believes the best way to address this is by strengthening the anti-abuse rule in section FE 11 to ensure Inland Revenue has the tools to neutralise this sort of activity. It is unfair to penalise all taxpayers and force additional compliance costs on all taxpayers subject to this regime simply because a small group of taxpayers (if any) are abusing the rules.

4.37 A further option would be to require disclosure when the tax return is filed of whether taxpayers have paid down / capitalised debt at the end of the income year. This would allow Inland Revenue to appropriately target its review / audit resources.

4.38 At our workshop, Officials asked the Group to consider whether an average of the opening and closing values would be palatable. In light of the Group's comments above regarding the materiality of the issue we consider such an approach to be unnecessary. The Group also notes that this could disadvantage Inland Revenue in instances where the taxpayer breaches the thin capitalisation threshold towards the end of year. For the sake of simplicity the Group submits that the existing year-end measurement option be retained.

Australian thin capitalisation rules

4.39 The Group has mentioned a number of features of the Australian thin capitalisation rules which are more favourable than the New Zealand rules. The Group considers there is merit in considering an alignment in the rules between the countries. We set out in Appendix Five a summary of the rules in each country.

Application date / grandparenting

4.40 The discussion document notes that, if implemented, the proposals will apply from the beginning of the first income year after enactment (except for the proposals

relating to non-resident owning bodies). The Group submits that this application date is inappropriate for such fundamental proposals.

4.41 If the interest rate cap proceeds in its current form, at a minimum, all existing APAs with respect to debt pricing should be preserved for the term of the APA, particularly if they are bilateral APAs. Taxpayers incur significant costs to reach those agreements with Inland Revenue. It would significantly damage New Zealand's reputation on an international scale if the Government were to legislatively override those agreements. The Group also submits that existing debt arrangements that have a finite term should also be grandparented for the life of the arrangement. Investment decisions were made on the legitimate expectation of the continuation of New Zealand's existing tax rules. The changes have the potential to materially alter returns on investment which again may harm New Zealand's reputation as an investment destination.

4.42 We also submit that taxpayers should be afforded greater opportunity to restructure their balance sheets prior to the remaining proposals taking effect. The proposal with respect to non-debt liabilities will materially impact some taxpayers. Those taxpayers need time to get their affairs in order. The Group submits that the proposals should apply from a specified income year more than 1 income year into the future. This provides taxpayers with greater certainty as to when the rules will apply from. The Closely Held Companies bill was enacted on 30 March 2017, meaning that for March balance date taxpayers a number of reforms came into effect two days later, the Group does not want to see this happen with these proposals.

4.43 The Group notes that the last substantial changes to the thin capitalisation rules were included in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*. These rules received Royal Assent on 30 June 2014 and took effect from 1 April 2015 the 2015/16 and later income years. The Group submits that at least a similar lead in time should also apply to any taxpayer unfavourable changes.

APPENDIX FIVE: COMPARISON OF NEW ZEALAND AND AUSTRALIAN THIN CAPITALISATION RULES

	New Zealand	Australia
Ratio	60% of assets	60% of net Australian investments
Debt	Debt is limited to financial arrangements that provide money and give rise to deductions under the financial arrangement rules (does not include non-interest bearing debt).	Debt capital of the entity that gives rise to a debt deduction for an income year.
Assets	Assets means the aggregate of all the taxpayer's assets or the assets of another group member. Broadly the taxpayer may elect to measure total assets by: - Value of the assets shown in the financial statements of the entity's NZ group; or - The net current value of the assets; or Proposal to remove the net current value option.	Base rule is to value as permitted in relevant accounting standards (from AIFRS).[16] Measurement based on an independent valuation is also permitted. The ATO has the discretion to substitute values where it believes that the taxpayer has overvalued its assets or undervalued its liabilities.[17] Some deviations permitted as below. 1. Deferred tax assets are excluded. 2. Defined (employment) benefit plans - Amounts related to defined benefit superannuation plans are not recognised as assets/liabilities. 3. Intangible assets[18] - Internally generated intangible assets can be recognised for thin capitalisation purposes even if not recognised under AASB 138 if: ○ The reason that the standard does not recognise them is because it is impossible to distinguish between the cost of acquiring that item and of developing the entity's business as a whole; and

[16] ITAA 1997, Div. 820-680(1)
[17] ITAA 1997, Div. 820-690.
[18] ITAA 1997, Div. 820-684(1) and (2).

		○ that item otherwise meets the criteria for an internally generated intangible asset under AASB 138. - Intangibles with no active market. Entities can also choose to revalue intangibles with no active market (this would be prevented under AASB 138). [19]
Treatment of non-debt liabilities	Not counted for thin capitalisation purposes. Propose to include all non-debt liabilities except for non-interest bearing shareholder debt.	Non-debt liabilities defined as liabilities other than: - any debt capital of the entity - any equity interest in the entity; - if the entity is a corporate tax entity—a provision for a distribution of profit; - if not a corporate tax entity—a provision for a distribution to the entity's members; - any liability of the entity under a securities loan arrangement if, as at that time, the entity: ○ has received amounts for the sale of securities (other than any fees associated with the sale) under the arrangement; and ○ has not repurchased the securities under the arrangement; - a liability of the entity, to the extent that it meets the conditions for being taken into account in working out the borrowed securities amount of the entity as at that time. [20] - Also excludes deferred tax liabilities.
Debt measurement date	At the election of the taxpayer can be calculated either: - Daily; or	Three possible tests:[21] - Opening and closing balance method (i.e. measure on opening

[19] ITAA 1997, Div. 820-684(5).
[20] Div 995 ITAA97
[21] ITAA 1997, Div. 820-635 / Div. 820-640 / Div. 820-645https://www.ato.gov.au/Business/Thin-capitalisation/Understanding-thin-capitalisation/Average-values-for-debt-and-capital-levels/Average-values/

	- Quarterly; or - At the end of the income year.	date and closing date for the year) - 3 measurement days method (i.e. measure on opening date, mid year date and closing date for the year) - Frequent measurement method (i.e. quarterly or more frequently, as desired)
Asset measurement date	At the election of the taxpayer can be calculated either: - Daily; or - Quarterly; or - At the end of the income year.	Three possible tests: - Opening and closing balance method (i.e. measure on opening date and closing date for the year) - 3 measurement days method (i.e. measure on opening date, mid year date and closing date for the year) - Frequent measurement method (i.e. quarterly or more frequently, as desired)

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Base Erosion and Profit-Shifting (BEPS) – Strengthening our Interest limitation rules

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on *BEPS – Strengthening Our Interest Limitation Rules: A Government discussion document* (discussion document).

2. This submission focuses on the proposed cap on the deduction permitted for interest paid by a New Zealand borrower to a non-resident related-party lender.

Proposed interest deduction cap

3. The Government proposes a cap on the amount of interest deductible by a New Zealand borrower on debt funding from a related non-resident party by reference to the interest rate that the borrower's ultimate parent could borrow at on standard terms.

4. The maximum permitted deduction to the New Zealand borrower would be capped as follows:

   a) where the ultimate parent of the borrower has a credit rating for senior unsecured debt (and the New Zealand borrower does not), the yield derived from appropriate senior unsecured corporate bonds for that credit rating, plus a margin (the margin yet to be determined);

   b) where the New Zealand borrower has a credit rating, the lower of:

      (i) the yield derived from appropriate senior unsecured corporate bonds for the parent's credit rating, plus a margin (yet to be determined); and

      (ii) the yield derived from appropriate senior unsecured corporate bonds for the New Zealand group's credit rating;

   c) where the ultimate parent has no credit rating, the interest rate that would apply if the parent raised senior unsecured debt on standard terms, plus a margin (yet to be determined); and

   d) where there is no ultimate parent, the interest rate that would apply if the New Zealand group raised senior unsecured debt on standard terms (with no margin) such rate being

priced on an amount of "arm's length debt" or, alternatively, by deeming related party debt to be equity in determining the borrower's creditworthiness.

5. If the term of a loan exceeds five years, the maximum permitted interest deduction would be determined as if the loan had a five year term.

6. The proposed cap on interest deductions claimable by a New Zealand borrower on funding from a related non-resident party is referred to in this submission as the interest deduction cap.

7. This submission addresses:

   - the justifications advanced in the discussion document in support of the interest deduction cap and questions whether those justifications support a departure from the transfer pricing regime for related-party debt arrangements;

   - whether the interest deduction cap involves a departure from the arm's length principle contained in Article 9 of the OECD Model Tax Convention on Income and on Capital (the Model Convention) included in New Zealand's double taxation agreements; and

   - the practical impact of any such departure, being the risk of economic double taxation of multi-national groups advancing debt to New Zealand subsidiaries.

Summary of proposed alternative regime

8. The Law Society submits that the analysis contained in this submission supports a balancing of Inland Revenue concerns and the importance of the arm's length principle through adoption of an approach that incorporates the interest deduction cap as a safe-harbour adopted by taxpayer election.

9. Under this alternative proposal taxpayers could deduct at least an amount of interest up to the interest deduction cap. However, if a taxpayer could establish that the application of the arm's length principle supported a greater level of deductible interest in New Zealand then that level of deduction should be permitted.

10. It is noted in the context of advancing this proposal the changes to the transfer pricing regime proposed in the discussion document "BEPS – Transfer pricing and permanent establishment avoidance" (the Transfer Pricing Discussion Document) should in large measure mitigate the concerns expressed and justifications offered by the Government in support of the interest deduction cap.

The justification for change

11. The Government offers its justification for the interest deduction cap at paragraphs 3.7 – 3.13 of the discussion document by reference to issues identified in connection with the current application of the transfer pricing regime to related-party debt arrangements.

12. The Law Society observes that all of these issues are either one or more of the following:

    (a) not unique to the transfer pricing rules;

    (b) not specific to related-party debt arrangements; or

    (c) mitigated by certain of the proposals in the Transfer Pricing Discussion Document.

13. By way of elaboration of the last category, the following related measures are proposed in the Transfer Pricing Discussion Document:

(a) the requirement to have regard to both the legal and economic substance of relationship between parties and of a tested transaction in determining an arm's length price (paragraphs 5.26 – 5.33);

(b) the non-recognition of commercially unrealistic or irrational transactions (paragraphs 5.34 – 5.40); and

(c) the proposed reference in the rules to "arm's length conditions" to permit testing of the conditions that arm's length parties would be willing to accept (paragraphs 5.41 and 5.42).

14. The Transfer Pricing Discussion Document also proposes certain administrative changes in connection with the regime including the reversal of the burden of proof (paragraph 5.43 – 5.48).

15. The table below repeats the issues raised in the discussion document and comments on why the Law Society does not consider that they form sound justification for the interest deduction cap.

Issue	Comment
The application of the transfer pricing rules is "resource intensive" (paragraphs 3.1 and 3.13)	This is a general criticism of the transfer pricing rules and the arm's length principle. It is not a concern specific to debt arrangements. Transfer pricing analysis of all internal arrangements can be resource intensive requiring the identification and testing of comparable arrangements and the consideration of other fact-specific considerations. In any case, the concern may be mitigated from Inland Revenue's perspective as a result of the administrative proposals in the Transfer Pricing Discussion Document.
"[C]ommercial pressures" will not "drive the borrower to try to obtain as low an interest rate as possible – for example, by providing security on a loan if possible, and by ensuring their credit rating is not adversely affected by the amount being borrowed." (paragraphs 3.8 and 3.9)	The absence of actual commercial pressure or tension is assumed in related party arrangements and gives rise to the need to impose the arm's length standard. The absence of such tension is also not specific to debt arrangements. Commercial pressures will seldom drive the inclusion (or non-inclusion) of terms or conditions in any related party transaction. The issue is addressed by the arm's length principle as strengthened by proposals in the Transfer Pricing Discussion Document to (a) disregard commercially unrealistic/irrational transactions and (b) incorporate the concept of "arm's length conditions".
"A related party interest payment, such as from the New Zealand subsidiary of a multinational to its	The absence of an external cost is a feature of many internal transactions. It is not specific to debt funding

foreign parent, is not a true expense from the perspective of the company's shareholders. Rather, it is a transfer from one group member to another." (Paragraph 3.9).	arrangements. The arm's length principle operates to ensure that the "transfer" from one group member to another is made on arm's length terms. It is also the case that many related party transactions do involve a cost at a group level. A group is likely to have external borrowings. Internal group advances then ensure appropriate allocation of that external cost to group members. Such allocation is entirely appropriate if made in compliance with the arm's length principle. In any case intra-group funding arrangements have very real consequences in terms of international taxation. The interest paid will give rise to income in the lender jurisdiction and withholding tax will be imposed in the borrower jurisdiction.
"Indeed, it can be profitable to increase the interest rate on related-party debt – for example, if the value of the interest deduction is higher than the tax cost on the resulting interest income." (Paragraph 3.9).	This statement is not specific to debt arrangements and is an obvious point justifying the application of the arm's length principle to all cross border related-party transfers.
"[R]elated party transactions are fundamentally different to third-party transactions. Factors that increase the riskiness of a loan between unrelated-parties (such as whether the debt can be converted into shares, or the total indebtedness of the borrower) are less relevant in a related-party context." (Paragraph 3.10).	The transfer pricing rules recognise that related party transactions are fundamentally different because of the assumed absence of commercial tension. This is what gives rise to the arm's length standard to ensure appropriate tax outcomes are recognised under such arrangements. The absence of commercial pressure and group context will lead to an indifference to a range of factors, terms and connected arrangements that could impact on the stand-alone "riskiness" of a loan transaction or any other arrangement. This consideration is not limited to funding arrangements. Further, the issue is addressed by the arm's length principle as strengthened by proposals in the Transfer Pricing Discussion Document to (a) disregard commercially unrealistic/irrational transactions and (b) incorporate the concept of "arm's length conditions".
"Some related-party loans feature unnecessary and uncommercial terms (such as being repayable on demand or having extremely long terms) that are used to justify a high interest rate. Simply making the related party debt subordinated or subject to optionality may also be used as justifications for a high interest rate. In other cases, a very high level of	As above noting in particular the utility of the proposed changes in the Transfer Pricing Discussion Document to mitigate those concerns. Individual conditions on which funding is advanced could be tested against the proposed "arm's length conditions" test. If the terms of an arrangement become commerciality unrealistic or irrational such

related party debt may be loaded into a New Zealand subsidiary to depress the subsidiary's credit rating, which also is used to justify a higher interest rate." (paragraph 3.11)	that an arrangement would not be entered into on those terms between third parties, the arrangement could be disregarded.
"It can be difficult to challenge such arrangements under the transfer pricing rules as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and a similarly high interest rate…. However, we are concerned that they may still provide scope for taxpayers to choose to borrow from related parties using higher-priced forms of debt than they would typically choose when borrowing from third parties." (Paragraph 3.12)	If it is difficult for Inland Revenue to challenge the arrangement because the arrangement is arm's length that suggests that the tax effect of the arrangement should be allowed to stand. If the comment is intending to suggest that in some cases comparables referenced by the taxpayer are not appropriate comparables, then the proposed administrative changes to the transfer pricing regime should allow that to be properly tested.
"[T]he highly factual and subjective nature of transfer pricing can make the rules complex and uncertain to apply…. [C]omplying with the transfer pricing rules [is] a resource-intensive exercise which can have high compliance costs and risks of errors." (Paragraph 3.13)	This concern is not specific to debt arrangements. It is suggested that greater complexity and uncertainty could be expected to arise in cases involving integrated production of highly specialised goods, unique intangibles or in the provision of highly specialised services. The uncertainty involved in the application of the arm's length principle is recognised and tolerated by the OECD. Difficulties in the comparability analysis led to recognition in the OECD Guidelines that "*transfer pricing is not an exact science but does require the exercise of judgement on the part of both tax administration and taxpayer*." (1.13). And later at 2.0: "*Tax administrators should hesitate from making minor or marginal adjustments. In general, the parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and the preference for higher degrees of comparability and a more direct and closer relationship to the transaction.*"
"Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue." (Paragraph 3.13 and see paragraph 3.17)).	This issue is not unique to transfer pricing matters.

16. The Law Society also notes the inconsistency in the justification for the interest deduction cap based on the resource intensive and complex nature of compliance with the transfer pricing regime and comments made in the discussion document about the likely cost and complexity involved in compliance with the proposed cap. In addressing the proposed de minimis threshold for loans with a principal value of NZ$10m or less, the discussion document comments at paragraphs 3.46 and 3.47:

"Applying this interest rate cap will likely require the engagement of financial analysts or other subject matter experts, who have access to bond yield data and are able to perform the required calculations. This is no different to the situation at present – firms borrowing from related-parties should be involving subject matter experts to perform comparability analysis and ensure that the interest rate (and the other terms and conditions) of the related-party loan is reasonable.

We therefore believe this proposal will not result in increased compliance costs; indeed compliance costs may reduce in some circumstances."

17. Any justification for the interest deduction cap based on the (relative) cost or complexity of compliance with transfer pricing is ill-founded if the counterfactual under the proposed cap is net neutral (or at best the belief that in some cases compliance costs might reduce).

18. The Law Society submits that no sound justification has been advanced for the proposed departure from the transfer pricing regime.

Inconsistency with the arm's length principle

19. The Government comments in general terms in the discussion document that the interest rate cap would ensure that the interest rate on related-party loans is roughly in line with the interest rate the borrower would agree to with a third party (paragraphs 3.17 and 3.21).

20. Later at paragraphs 3.57 and 3.58 the Government comments that the interest deduction cap is consistent with the existing thin capitalisation rules which are non-arm's length based but:

    "…are consistent with the arm's length principle insofar as their effect is to assimilate the overall profits of the borrower with those which would have occurred in arm's length situations. This is on the basis that, while a thin capitalisation regime does not expressly refer to arm's length amounts, it aims to approximate a similar overall level of interest expense for a taxpayer as would arise in arm's length situations."

21. Government reasons further at 3.58 that:

    "…independent lenders take the credit rating of the group into account when determining the interest rate payable by a New Zealand subsidiary, even without an explicit parent guarantee. Therefore, the interest rate cap should generally produce a similar level of interest expense as would arise in arm's length situations. Consequently it should also be consistent with the arm's length principle."

22. The assimilation of the interest deduction cap to the existing thin capitalisation regime as a means to describe the outcome under the cap as consistent with the arm's length principle involves incorrect logic.

23. A thin capitalisation regime will only produce results consistent with the arm's length principle if it produces results that are consistent with an application of the arm's length principle. If the application of the rule produces an outcome inconsistent with the arm's length principle, then it is inconsistent with the arm's length principle. The assimilation of the interest deduction cap to internationally tolerated thin capitalisation regimes based on the amount of the debt not the price of the debt advanced has no bearing on the consistency of the results produced by the application of the rule with the arm's length principle. Consistency with the principle is best served by adherence to it.

24. A thin capitalisation regime is a base protection measurement mechanism applying safe harbours and tolerances set by reference to hard debt to asset percentages selected at a level to protect against the over-allocation of deductible expenditure to New Zealand without discouraging investment in New Zealand relative to our main competition for investment. It does not have at its heart an embedded arm's length principle in relation to the amount or price of debt.

25. Further, the statement that lenders take into account the credit rating of the group without explicit parental support involves significant overstatement. As Inland Revenue is aware, expert views differ on the appropriateness of a creditworthiness upgrading or uplift on the basis of implicit parent support absent contractual guarantees. It is a contentious issue on which we expect more considered guidance will become available in due course.

26. Even if some notching on account of implicit parental support is appropriate the extent of the upgrading is a fact-specific exercise taking into account the importance of the subsidiary to the group having regard to a number of factors including inter alia the subsidiary's contribution to global revenue, reputational/brand considerations and group perceptions of the strategic importance and potential of the market and industry in which the subsidiary operates.

27. There are other dangers in taking a parent's credit rating as a proxy for that applicable to a subsidiary. A parent group and New Zealand subsidiary might be exposed to very different risks. An operating subsidiary in New Zealand exposed to one market and industry could have a very different risk profile to a group holding company with risk spread across multiple investments in multiple jurisdictions.

28. If notching was considered to be appropriate in a given case then it is a fair question to ask whether the upgrading should be reflected in a deemed charge from borrower to parent similar in nature to a guarantee fee which would be expected to be paid to a party that permits its balance sheet to secure cheaper funding for a borrower.

29. The Law Society submits that whether an upgrading in creditworthiness on account of implicit parental support is appropriate in any given case is best tested under an individual transfer pricing analysis.

Significance of the departure from the arm's length principle

30. The departure from the arm's length principle is of real practical significance.

31. The arm's length principle as it is understood by our treaty partners is articulated in Article 9 paragraph 1 of the OECD Model Tax Convention on Income and on Capital (the Model Convention). That article provides:

> *"[Where] conditions are made or imposed between two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

32. Adjustments made in one jurisdiction as a result of the application of the arm's length principle could give rise to economic double taxation without a corresponding adjustment in the counterparty jurisdiction. Key to the elimination of economic double taxation is paragraph 2 of Article 9 of the Model Convention. It provides that:

"Where a Contracting State includes the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits."

33. The obligation imposed on a counterparty State to make a corresponding adjustment as a result of a transfer pricing adjustment made by the first State appears to be conditional on the first adjustment having been made in accordance with the arm's length principle in paragraph 1. Adjustments made under a regime that does not explicitly utilise the principle in informing the adjustment, like the proposed interest deduction cap, may not trigger the counterparty State obligation to make the corresponding adjustment.

34. This gives rise to the potential for economic double taxation of multinational groups. If a New Zealand subsidiary's deductions are limited under the interest deduction cap without a corresponding reduction in the amount of income taxed in the lender's jurisdiction, double taxation will result.

35. It is also difficult to see how that double taxation might be resolved between two States under the Article 25 Mutual Agreement Procedure when (presumably) the level of interest income recognised in the lender jurisdiction is based on traditional arm's length pricing principles and the permitted deduction to the borrower in New Zealand is not so based. New Zealand could not expect the lender jurisdiction to depart from the well tested and internationally normative arm's length principle. The cause of the double taxation will be New Zealand's internationally non-normative interest deduction cap.

Summary and alternative proposal

36. An analysis of the justifications advanced in the discussion document in support of the interest deduction cap suggests to the Law Society that there is no sound basis to depart from the transfer pricing regime for related-party debt arrangements.

37. The Law Society submits that the interest deduction cap cannot be expected to produce outcomes that correspond to outcomes produced following application of traditional arm's length pricing principles.

38. The practical result of the departure from the arm's length principle will be the economic double taxation of multi-national groups advancing debt to New Zealand subsidiaries.

39. The Law Society submits that a balancing of Inland Revenue concerns and the importance of the arm's length principle could be achieved through adoption of an approach that incorporates the interest deduction cap as a safe-harbour adopted by election of taxpayers. Taxpayers would be permitted to deduct at least an amount of interest up to the proposed cap. However, if a taxpayer could establish that the application of the arm's length principle supported a greater level of deductible interest in New Zealand then that level of deduction should be permitted.

40. It is noted in the context of advancing this proposal the changes to the transfer pricing regime proposed in the Transfer Pricing Discussion Document should in large measure mitigate the concerns expressed by the Government in support of the interest deduction cap.

Conclusion

41. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

Kathryn Beck
President

#027

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Strictly private and confidential

BEPS – Interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

12 May 2017

To whom it may concern,

InfraRed Capital Partners Limited, via its local Adviser, InfraRed Capital Partners (Australia) Pty Limited (together "**InfraRed**"), makes the following submission in relation to the Government Discussion Document titled "BEPS – Strengthening our interest limitation rules". The primary focus of this submission is the operation of the thin capitalisation regime and the proposed changes discussed in Chapter 5 as applied to government infrastructure procurements (ie. PPPs).

InfraRed makes this submission as an active equity investor in the New Zealand PPP sector, currently holding interests in the SecureFuture Wiri Group and the Wellington Gateway Partnership Group, delivering the Auckland South Correctional Facility and Transmission Gully Motorway projects, respectively.

Current state of play

The current thin capitalisation regime applies to any foreign investor that holds an equity interest of 50% or more of an asset or a group of foreign investors which in aggregate (in certain circumstances) hold 50% or more of the equity . Once inside the thin cap regime, the regime provides that the foreign investor may utilise tax deductible gearing in the NZ Project up to the greater of: (a) the safe harbour threshold of 60%; and (b) a level that is 110% of the level of gearing currently held in its World Wide Group. We interpret that the policy objective of this is to ensure that foreign investors do not gear local NZ entities disproportionately higher than entities that they invest in in other jurisdictions.

If the foreign investor is unable to satisfy this test then the interest on the excess portion of the project level debt is treated as non-deductible.

As an investor bidding for projects in the New Zealand market, it is important that tax rules:

i) are clearly understood so that their impact can be priced into the economic analysis
ii) apply in a consistent way so that they do not favour certain types of investor or structures
iii) do not make New Zealand uncompetitive when compared to other international markets competing for inward investment

Observations on current framework

The following observations highlight situations in which the above points are not always met:

- Project finance structures used to finance infrastructure projects typically have higher gearing levels than other arrangements (eg. corporate) and commonly exceed the safe harbour threshold. There are a number of reasons for this which include revenue credit quality, cost predictability and the generally tightly controlled nature of the structure (ie ring fenced). It is on this basis that arms-length third-party lenders are comfortable to lend at higher levels (up to 90%) on a non-recourse basis, compared to other structures. This maximisation of the cheapest form of private capital is a key feature in driving affordability/feasibility of these projects.
- The first order impact of the thin capitalisation rules is that it can drive the make-up of consortiums (to manage under the 50% non-resident threshold). This results in tax driving the level of participation in consortium with a corresponding reduction in participation and competition. This is sub optimal.
- Secondly, it can also drive the chosen investment structure (e.g. a company) which results in additional tax risks being imposed on consortium participants (e.g. loss continuity) which would not be the case if thin cap constraint did not dictate the investment choice. Again, this is sub optimal.
- Unless the investment (and its participants make up) can be structured so as to effectively fall outside the ambit of the thin capitalisation rules, the resulting participation by non-residents is further constrained. This is because in those circumstances, limb (a) of the thin cap test is generally failed, and so the project entity needs to satisfy limb (b) in order to avoid an interest deduction restriction, however, application of this test is not always simple in practice in project finance situations.
- Entities that invest in project finance structures are usually corporates or investments funds. As such the current thin capitalisation test requires you to compare the gearing levels of the project company to the gearing level in the corporate group or fund structure which does not seem an appropriate test in the context of a ring-fenced project finance structure. It is highly unlikely that the investing entity will be able demonstrate the required gearing levels (80%+ and as prepared on an accounting basis) to allow the underlying project company to utilise c. 90% gearing levels.
- Further, because the different projects in which the corporates / funds have invested will be in different phases of their lifecycle, a comparison of the gearing level of the project company to the gearing level of the investing entity is not appropriate. The thin capitalisation regime requires a minimum of an annual testing of the debt:asset ratio. An annual test that compares the gearing of say, a project entity in a build phase to a portfolio of projects companies which are in the operation phase will give different views on the level of gearing depending on the maturity of the project profile. Over the life of similar projects, comparable levels of gearing could be expected. However, an annual “snap shot” will not reflect this.
- Even if the debt:asset profile of the investor could be managed at the outset, the life of the assets means it is not possible to commit to that being the case for the life of the project.
- The measure of gearing is an accounting construct (Debt:Assets) so does not represent the same economic picture as simply looking at the amount of debt versus the amount of equity. Accounting practices also vary between different jurisdictions and legal structures (eg. partnerships vs trusts vs companies), as do account preparation dates. Additionally, the accounting treatment varies depending

on the amount of equity ownership in the underlying project (eg. consolidate or equity account). This further clouds the economic reality of the group.

- Additionally, determination of what entities to include in the World Wide Group can be complicated as investment funds may not prepare consolidated accounts.
- The impact of the above is that limb (b) does not provide the safety valve it should.

Impact on InfraRed's investment activity in New Zealand

The impact of the above is that InfraRed considers it is very difficult to satisfy the current thin cap test when applied to project finance structures in which InfraRed will take a 50%+ stake. This means that a significant portion of the third-party senior debt has to be treated as non-deductible, resulting in more tax being paid overall and earlier and increasing the cost of capital significantly. . This places the bid at a significant cost disadvantage versus a bid where a foreign investor does not have a 50%+ stake. Tax may therefore be a key factor in determining which investor delivers the lowest cost bid, which, we suggest, is not in the interests of the public sector procuring body.

Accordingly, when investing in NZ PPPs InfraRed is constrained in that it needs to remain under 50% of the project equity. This reduces the attractiveness of the various projects by reducing the absolute investment amount whilst the significant cost and time required to bid these projects remains fixed. Predominantly for this reason, InfraRed has declined recent opportunities to participate in smaller NZ PPPs (eg. schools procurements). This constraint also has second order impacts in constraining the liquidity of the projects, which will become more relevant as the New Zealand project profiles mature, i.e. secondary investors will not want to take 50%+ stakes in projects that have reached their operations phase.

InfraRed manages funds that invest in similarly geared PPP projects in the region and other markets globally. These funds do not seek to gear the NZ project entities disproportionately to project entities in other countries, however, for the reasons given above, it finds that it cannot meet the thin cap tests. This appears at odds with our perception of the underlying commercial rationale of the regime.

Overall, when InfraRed looks to invest in NZ it compares the forecast investment returns to those of investment opportunities in other regions. However, the way the thin cap rules currently operate has a negative impact on the returns from NZ investment opportunities making it harder to allocate capital to those opportunities.

Application to the Government Discussion Document

InfraRed supports the proposal for the safe harbour threshold to be able to be exceeded for infrastructure projects as a solution to the problems outlined above. As PPP projects are Government procured and financed on a non-recourse basis, the debt in these projects represents no BEPS risk

However, InfraRed does not support the view that related party debt is by definition "not arms-length". There is legitimate commercial rationale as to why an investor would hold equity and debt interests in a project or would seek to fund a project using shareholder funds rather than seeking external finance. Provided that the overall level of debt remains in line with the level that a third-party would lend to, and at a comparable rate, then InfraRed is of the view that this should remain deductible.There are currently a number of investors both in New Zealand and internationally who participate in the provision of both equity and senior debt pari passu

with third party banks. In these instances, it is common that the equity providers do not all participate in the debt, and the provision of the senior debt by an equity party is effectively taking the role of a third party lender. InfraRed is of the view that in these types of arrangements interest on the related party debt should remain deductible.

InfraRed firmly believes that the ability to use arms-length debt in excess of the safe harbour threshold should not depend on the specific legal structuring of the deal; the utilisation of limited partnership structures or alternatively company structures. Any change in the rules should ensure that this is the case.

Next Steps

InfraRed remains one of the larger foreign equity participants in NZ and has a great level of interest in continuing to invest significant funds in NZ projects over the foreseeable future. We would be happy to further engage with and discuss the Government's proposals to provide further perspective on how they relate to InfraRed's investment activity in New Zealand.

SUBMISSIONS

New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

Submissions received for the officials' issues paper *New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (March 2017).

Number	Submitter
001	Chartered Accountants Australia and New Zealand
002	PricewaterhouseCoopers
003	KPMG
004	Corporate Taxpayers Group
005	Ernst & Young Limited

#001

New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS

7 April 2017

Chartered Accountants Australia and New Zealand

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7 April 2017

New Zealand's implementation of the Multilateral Convention to Implement Tax Treat Related Measures to Prevent BEPS
c\- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Cath

New Zealand's implementation of the multilateral convention

We welcome the opportunity to submit our comments on the proposals for New Zealand's adoption of the Multilateral Convention (MLC).

CA ANZ supports the Government's adoption of the MLC. In principle we support the underlying aim of the MLC to counter tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no tax jurisdictions where there is little or no economic activity, resulting in little or no overall corporate tax being paid.

The MLC provides the easiest method of implementing the tax treaty related proposals resulting from the G20/OECD project on base erosion and profit shifting (BEPS) by amending the double tax agreements (DTAs) of the participating jurisdictions within a reasonable time.

However, we are concerned that the effects of the MLC will be far reaching and will apply to all taxpayers with cross-border activities and not just to those large multinational organisations whose arrangements triggered the BEPS project. It will also affect commercial transactions that have been structured in a particular way for commercial non-tax driven reasons.

Given the innovative nature of the MLC we also have concerns that significant unexpected issues will arise that will affect taxpayers. It will be critical that Inland Revenue provides adequate resources to New Zealand taxpayers when other jurisdictions try to tax income New Zealand has already taxed.

We support the proposals for New Zealand to adopt the following MLC provisions:

1. Article 5 – Relief of double taxation;
2. Article 6 – Preventing the granting of treaty benefits in inappropriate circumstances
3. Article 7 – Treaty anti-abuse rules
4. Article 8 – Dividend transfer transactions
5. Article 9 – Land rich company rules
6. Article 10 – Third State PE Rules
7. Article 11 – Application of tax agreements to restrict a party's right to tax its own residents
8. Article 11 – Right to tax own residents
9. Article 12 – Commissionaire arrangements and similar strategies
10. Article 13 – preparatory and auxiliary qualification

Our concerns with the proposals for Articles 3, 4, 14 and 18-26 and consolidated versions of the modified treaties are set out in the Appendix.

If you have questions about our submission please contact us.

Yours sincerely,

Teri Welham
Senior Tax Advocate

Professor Craig Elliffe
Tax Advisory Group

Appendix

Article 3 Transparent Entities

Article 3 is consistent with New Zealand's preferred treaty practice of including provisions in its bilateral treaties to ensure that treaty benefits are available for income derived by or through FTEs.

New Zealand intends to adopt Article 3 of the MLC across all of its covered tax agreements.

Submission

The effect of Article 3 on Collective Investment Vehicles (CIVs) in New Zealand with non-resident beneficiaries needs to be considered.

As a minimum, the treatment of CIVs should be addressed in Inland Revenue guidance.

Comment

The proposed amendments to Article 3, as currently drafted, may lead to a number of unintended adverse outcomes from a taxation perspective for investors who are presently investing through a CIV in a third State (i.e. a State that is neither the investment destination, nor the country of residence for the investor).

Article 4 – Dual resident entities

New Zealand's treaty practice has varied (with most of New Zealand's bilateral treaties prescribing the POEM as the determinative test) but has not previously permitted the competent authorities to decide on the extent of treaty benefits to be granted if the competent authorities are unable to agree on a single jurisdiction of residence.

Submission

New Zealand should consider not adopting Article 4.

Comment

In our view adopting the expanded criteria for determining a dual resident entity's treaty and requiring the competent authorities to attempt to agree on a single jurisdiction of residence will not improve the integrity of the current tie breaker rules nor provide any certainty of outcomes to taxpayers.

Our concerns arise because New Zealand has one of the widest corporate tax residency tests in the world. Consequently, there are a large number of New Zealand dual resident companies. A simple example is when a New Zealand company moves its CEO to Australia and, as a result, the company becomes a dual resident. We consider the expanded criteria requiring the competent authorities to agree on a single jurisdiction will result in significant costs and lengthy delays. It is difficult to see how the competent authorities will agree between place of incorporation and place of effective management

By way of illustration, consider the New Zealand/United States treaty tiebreaker test, which is consistent with proposed Article 4. We understand the question of dual residence has never been settled by mutual agreement between the United States and New Zealand tax authorities. The United States has always refused to resolve the issue.

Further support for not adopting Article 4 is that there is no evidence of problems arising with our current self-assessment regime, which appears to be working well.

Article 14 – Splitting up of contracts

Article 14 is consistent with New Zealand's preferred treaty practice of circumventing deemed PE time thresholds.

New Zealand intends to adopt Article 14 (and possibly enter the reservation permitted by Article 14(3)(b) to exclude bilateral treaties that deem a PE to exist in relation to exploration for or exploitation of natural resources) across its covered tax agreements.

Submission

The issues need to be given further consideration.

Comment

In our view, Article 14 will disadvantage a number of taxpayers for whom splitting of contracts occurs for genuine commercial reasons and is not abusive. To illustrate, a multi-national has subsidiaries in different jurisdictions, with one subsidiary carrying on an engineering consultancy business and another subsidiary carrying on a construction business. Each subsidiary tenders for different parts of the same infrastructure project. Use of the general domestic anti-avoidance provisions or the rule provided in Article 6 of the MLC should be adequate to deal with aggressive avoidance situations.

Articles 18-26 – Arbitration

Part VI is consistent with New Zealand's commitment to implement binding MAP arbitration in its bilateral tax treaties.

New Zealand intends to adopt Article 23(1) – "final offer" or "last best offer" – but accept independent arbitration. It will also require undertakings of confidentiality and reserve the right not to include arbitration provisions in a CTA with jurisdictions that do not require the same (23(6) and (7)).

Submission

New Zealand should not choose to include a DTA as a CTA where the other country chooses not to include the arbitration provisions.

Comment

New Zealand's approach to adopt "final offer" or "last best offer" arbitration but to accept "independent opinion" arbitration if the other party to the CTA chooses this (by entering a reservation) is consistent with New Zealand's model treaty provision. We therefore support adopting Article 23(1). However, we are concerned about New Zealand choosing to include a DTA as a CTA where the other country chooses not to include the arbitration provisions. The extensive changes to international tax rules resulting from the BEPS projects will create divergent interpretations which are likely to create uncertainty and potential conflicts. Without an arbitration process there will be no effective determination. The arbitration process is a means of reducing the risk of conflicting decisions and uncertainty. That is, we are concerned with a situation where an overseas jurisdiction, under a CTA, applies the BEPs provisions in an aggressive way against New Zealand-based tax payers in an overseas jurisdiction. This will leave our taxpayers exposed, with ineffective methods of arbitration not agreed.

GAAR

Submission

Further consideration should be given to entering a free form reservation in respect to arbitration to carve out cases that involve the application of s BG 1 of the Income Tax Act.

Comment

It is not clear that New Zealand's intention to enter a free form reservation in respect of arbitration to carve out cases that involve the application of New Zealand's general anti-

avoidance rule in s BG 1 Income Tax Act 2007 is appropriate. By reserving against these provisions New Zealand effectively prevents mandatory arbitration from being used where the treaty is being abused. In our view mandatory arbitration is essential. It allows the other party to the CTA to agree the treaty is being abused.

Confidentiality

Submission

Further consideration should be given to the proposal to require undertakings of confidentiality of the arbitration proceedings.

Comment

New Zealand's proposal to require undertakings of confidentiality may lead to unintended consequences. For example, not all listed companies may be able to participate in confidential arbitration because they have continuous disclosure obligations to notify the Stock Exchange of any change in the tax status of the company.

Consolidated versions of modified treaties

Submission

The Government should publish and maintain consolidated versions of modified treaties.

Comment

Paragraph 4.18 of the Discussion Document states that the Government will not be producing consolidated versions of each DTA modified by the MLC. This is consistent with existing practice for amending protocols.

Although this is consistent with the current practices for treaties, overlaying MLC amendments will introduce added complexity which we believe justifies a different approach. We consider it is inappropriate for Government to abdicate responsibility for communicating the effects of the MLC.

In our view, the applicable MLC amendments should be consolidated with the existing bi-lateral treaties and maintained on the New Zealand legislation website.

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Substantive BEPS provisions in the multilateral instrument

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Agree / disagree
1. Neutralising the effects of hybrid mismatch arrangements that have a treaty aspect (Action 2 report)	**Fiscally transparent entities** The MLI introduces or amends a fiscally transparent entity (FTE) provision. FTEs (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The MLI provision clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident. New Zealand already includes this provision (or an equivalent provision) in its DTAs with Australia, United States, Chile and Japan. *Article 3 of the MLI*	No	Yes	See our submission
	Dual resident entities The MLI introduces or amends a dual resident entity (DRE) tie breaker provision. Like FTEs, DREs can be used to take advantage of arbitrage opportunities. The proposed provision will require CAs to agree the residence status of a DRE and the DRE will only be entitled to such treaty benefits as the CAs agree. *Article 4 of the MLI*	No	Yes	See our Submission
	Relief of double taxation The MLI allows countries to strengthen their application of the exemption method to relieve double taxation. New Zealand already applies the (more robust) credit method in all of its DTAs, and therefore proposes not to adopt any of the options. *Article 5 of the MLI*	No	Not applicable	Yes
2. Preventing the granting of treaty benefits in inappropriate circumstances (Action 6 report)	**Preamble language – minimum standard** The MLI will amend the preamble to DTAs to emphasise that as well as aiming to relieve double taxation, the treaty also aims to prevent opportunities for non-taxation, reduced taxation or tax avoidance. *Article 6(1) and (2) of the MLI*	Yes	Yes	Yes
	Preamble language – optional amendment The MLI allows countries to adopt the following optional amendment to the preamble to DTAs: “Desiring to further develop their economic relationship and to enhance their co-operation in tax matters,”	No	Yes	Yes

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Agree / disagree
	Article 6(3) and (6) of the MLI			
	Treaty anti-abuse rules The MLI requires jurisdictions to introduce an anti-abuse rule into DTAs. Jurisdictions can meet this minimum requirement in one of three ways: 1. a principal purpose test (PPT) alone; 2. a PPT plus a "simplified limitation on benefits" (LOB) clause. The LOB is a mechanical provision that seeks to identify, through a series of black-letter tests, whether a person is genuinely entitled to the benefits of a DTA; or 3. enter into bilateral negotiations to include a detailed LOB provision plus a PPT or anti-conduit rules. In the case of New Zealand, officials' favour adopting a PPT alone. The PPT is very similar to New Zealand's domestic law GAAR and will deny treaty benefits if the principal purpose of an arrangement was to secure those benefits. Also, in officials' view, it generally covers the same treaty shopping issues as the alternative approaches. *Article 7 of the MLI*	Yes	Yes	Yes
	Dividend transfer transactions The MLI introduces a provision that requires shares to be held for a minimum of 365 days for the shareholder to be entitled to the reduced withholding tax (WHT) rates on dividends. This is to stop shareholders buying shares temporarily to access the reduced WHT rates and then immediately selling them. *Article 8 of the MLI*	No	Yes	Yes
	Land rich company rules The MLI introduces a treaty provision that strengthens the anti-abuse "land-rich company" test (land rich companies are companies whose assets are mainly land). Some treaties do not contain this provision at all, so the MLI also allows it to be inserted into those treaties. The new rule reinforces the position that the source jurisdiction can tax land held by non-resident owners in the other jurisdiction through corporate vehicles. To prevent artificial and temporary dilution of the amount of land held by a company just before sale, the MLI provision requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares.	No	Yes	Yes

CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Agree / disagree
	The MLI provision also ensures the same rule applies to other investment vehicles such as partnerships and trusts. *Article 9 of the MLI*			
	Third-state PE rules The MLI introduces a treaty provision that denies treaty benefits in the case of income derived by a PE of a resident of one of the parties to the DTA, where that PE is situated in a low tax third-state. *Article 10 of the MLI*	No	Yes	Yes
	Right to tax own residents The MLI introduces a provision that preserves a jurisdiction's right to tax its own residents (for example, this prevents New Zealand residents engaged in a tax avoidance arrangement claiming a DTA prevents New Zealand from using the domestic law GAAR to impose tax). *Article 11 of the MLI*	No	Yes	Yes
3. Preventing the artificial avoidance of PE status	**Commissionaire arrangements and similar strategies** Currently, a number of artificial structures including the civil law concept of a "commissionaire" can be used to avoid having a PE in a jurisdiction. A new provision will deem non-residents using these structures to have a PE in the jurisdiction. *Articles 12 and 15 of the MLI*	No	Yes	Yes
	Specific activity exemptions – preparatory and auxiliary qualification Certain specific activities carried on in a jurisdiction are deemed **not** to constitute a PE (for example, premises used for simply storing goods or stock maintained for display or delivery). These specific carve-outs from the PE definition allowed quite substantial economic activities to fall within them. The MLI proposes clarifying that the specific carve-outs listed in the DTA must be subject to an additional requirement that they be "preparatory and auxiliary" in nature. There are two options for dealing with this issues – Option A (which New Zealand favours) which subjects all of the existing specific activities to an explicit "preparatory and auxiliary" test, and Option B, which does not subject the specific activities to the "preparatory and auxiliary" test (because these activities are considered to be inherently	No	Yes	Yes

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Agree / disagree
	preparatory and auxiliary in nature), but subjects any other activity or combination of activities to the "preparatory and auxiliary" test. *Articles 13 and 15 of the MLI*			
	Specific activity exemptions – Anti-fragmentation rule The MLI introduces an "anti-fragmentation" rule that will prevent an enterprise from dividing up all of its activities so that related parties each carry on a separate part of the business (that fall within the PE exceptions), but taken together they constitute a PE. *Articles 13 and 15 of the MLI*	No	Yes	See our submission
	Anti-contract splitting rule Currently a construction, installation or building project does not constitute a PE unless it last for more 12 months. Entities were abusing this 12 month limit by having back-to-back 12 month contracts so they never exceeded the 12 month threshold. Generally the contracts were undertaken by different companies within the same group of companies. The new an "anti-contract splitting" rule will aggregate related projects to prevent PE avoidance. *Articles 14 and 15 of the MLI*	No	Yes	See our submission
4. Providing improved mechanisms for effective dispute resolution	**MAP – access to the CAs of either jurisdiction** In covered tax agreements that do not already have it, the MLI will introduce a provision allowing taxpayers to request mutual agreement procedure (MAP) in cases where they believe taxation is not in accordance with the treaty. If a MAP provision is already contained in a DTA, the MLI will amend it to allow taxpayers to approach the CA of *either* jurisdiction to resolve uncertainty as to how the DTA applies (New Zealand's DTAs currently contain MAP provisions, but taxpayers are only entitled to approach the CA of the jurisdiction of which they are a resident). *Article 16 of the MLI*	Yes	Yes	See our submission
	MAP – corresponding adjustment Requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. *Article 17 of the MLI*	No	Yes	

BEPS measure	Detail	Minimum standard	Should NZ adopt?	Agree / disagree
	Arbitration If, under the MAP process, the CAs do not agree on the correct interpretation of the DTA, the CAs can submit the matter to an independent arbitrator (or a panel of three arbitrators) for decision. The arbitrators will decide which of the CAs is correct. The CAs are generally bound by the decision of the arbitrators, but the taxpayer is not. Therefore, the taxpayer could pursue a court case if it disagrees with the arbitrators' decision. New Zealand's approach is to adopt what is referred to as "final offer" or "last best offer" arbitration (in Article 23(1)), but to accept "independent opinion" arbitration if the other party to the Covered Tax Agreement chooses this (by entering a reservation under Article 23(2)). In the case of "independent opinion" arbitration, New Zealand will adopt Article 24(2) and (3) which means that the arbitrators' decision will not be binding on the CAs if they come to an alternative resolution of all unresolved issues within 3 calendar months of the delivery of the arbitrators' decision. New Zealand also proposes to require undertakings of confidentiality by all parties involved in arbitration (Article 23(5)) and reserves the right not to include arbitration provisions in Covered Tax Agreements with jurisdictions that do not require the same (Article 23(6) and (7)). New Zealand intends to enter a free form reservation in respect to arbitration to carve out cases that involve the application of New Zealand's general anti-avoidance rule contained in section BG 1 of the Income Tax Act 2007. *Articles 18 – 26 of the MLI*	No	Yes	See our submission

#002

Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

(sent via email: policy.webmaster@ird.govt.nz)

7 April 2017

New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI)

Dear Madam

Thank you for the opportunity to comment on the Discussion Document (DD). We appreciate that participating in OECD and G20 initiatives to target base erosion and profit shifting globally is a key focus for the government.

We have set out below a number of comments that we would like Officials to consider in relation to the implementation of the MLI.

Notification of entry into effect for specific Covered Tax Agreements should be made earlier (DD Para 4.14)

We appreciate the Government's proposal to publicly announce when the MLI comes into force for each of New Zealand's DTAs. To assist with certainty and to give taxpayers the maximum opportunity possible to prepare for the modification of a DTA, it would be helpful if the Government could also publicly announce:

- the list of DTAs it wishes to modify as notified to the OECD Depository upon signing of the MLI;
- any DTAs it later adds as Covered Tax Agreements; and
- when a jurisdiction which is a party to a Covered Tax Agreement has submitted its instrument of ratification to the OECD Depository (upon notification being received from the OECD Depository) and expected date that the MLI will come into force for that DTA.

Domestic law time limit for tax refunds should be extended (DD Para 4.17)

A taxpayer should be able to claim a tax refund from Inland Revenue if that is the outcome of a Mutual Agreement Procedure (MAP) and Mandatory Binding Arbitration. Given the length of time these proceedings can take, the ability to claim the refund should not be restricted to the 4-year period currently provided for in section RM 2 of the Income Tax Act 2007. Section 78B of the Tax Administration Act 1994 could be amended to allow for an extension of time to claim a refund.

Any matter which is subject to MAP should be able to be subject to Mandatory Binding Arbitration (DD Appendix Para 4)

The policy aim with respect to the proposed reservation to Article 18 of the MLI for section BG 1 of the Income Tax Act 2007 is not clear. The purpose of the new arbitration mechanism is to improve the MAP dispute resolution process – in our view, any matter which is subject to the MAP should also be able to be subject to Mandatory Binding Arbitration because it will assist taxpayers to achieve a more timely resolution of disputes. Perhaps it would be more appropriate for section BG 1 to be reserved from the MAP (and as a consequence not able to be subject to Mandatory Binding Arbitration).

Should the reservation with respect to section BG 1 be extended to apply to the proposed permanent establishment anti-avoidance rule (DD Appendix Para 4)?

If the reservation to Article 18 of the MLI for section BG 1 is to be made, it may be helpful in achieving policy aims and clarity for taxpayers if the reservation extends to the proposed permanent establishment anti-avoidance rule (*BEPS – Transfer pricing and permanent establishment avoidance*).

General

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely

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18 April 2017

Supplementary submission: New Zealand's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

Dear Madam

Further to our submission dated 7 April 2017 on the implementation of the Multilateral Instrument (MLI) in NZ, we would like to make one further submission. We apologise for our original omission.

NZ should not elect to apply Article 4 of the MLI (Dual resident companies)

NZ should retain the tie breaker test for corporate tax residence in its double tax agreements. In our experience over the past 10 years, dual residence has generally arisen inadvertently where a company incorporated in one jurisdiction is effectively managed in another, and not as a result of tax planning. Removing the tie breaker test will introduce unnecessary uncertainty for a dual resident company.

Applying for a Competent Authority determination in this situation is a time consuming solution, particularly bearing mind delays already experienced by taxpayers when a tax authority in another jurisdiction is asked to certify their tax residence. A taxpayer faces uncertainty and is at risk of double tax during this time period, which it may find difficult to recover. For example, it can take more than 6 months for a taxpayer to get a certificate of residency from the IRS, and that is in a situation where the IRS is not required to reach agreement with any other competent authority.

Removal of the tie breaker test in favour of a competent authority decision will also place an unnecessary burden on competent authorities, which in many cases are already stretched for resources.

A number of NZ tax advantages which could be obtained by a company being a dual resident have been eliminated by NZ's domestic legislation already, such as an inability to use a loss to offset income of group companies, or join a tax consolidated group. Any residual concerns Officials have around the use of dual resident companies for tax avoidance purposes should be specifically dealt with in the pending hybrid rules.

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely

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Our ref: 170410MLIsubmission

Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

10 April 2017

Dear Madam

KPMG submission - NZ's implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

Multi-lateral instrument ("the MLI")

We welcome the opportunity to submit on New Zealand's implementation of the MLI.

Our submissions are more of a general nature than a detailed analysis of the MLI articles and New Zealand's position in respect of them. This is because of the time available but also because of the difficulty of determining what the MLI will actually achieve: this is dependent on New Zealand and other countries' positions. Both remain uncertain.

Ability to enter into the MLI

We acknowledge firstly that New Zealand's Government has the constitutional ability to decide New Zealand's tax treaty position. It therefore makes sense that its policy is achieved efficiently through the MLI so that our double tax agreements ("DTA") are aligned with that policy in the shortest time at the least cost.

Lack of transparency and consultation

Despite the constitutional position, it is also clear that in the current environment there is a demand for transparency and actual consultation for New Zealand's treaties. That has not occurred with New Zealand's decision to sign the MLI.

We refer to the public debate on the now defunct Trans-Pacific Partnership Agreement and also the United Kingdom court cases on the constitutional position to give effect to the Brexit referendum. The first clearly showed that a "trust us to do the right thing" approach is not widely accepted. The second shows that the Crown's position is not unfettered. The decision to enter into a treaty may be reserved to the Crown but its domestic effect must be given through Parliament. (This is also evidenced by Parliamentary Select Committee oversight of the tax treaty process.)

The MLI has been developed, in our view, with minimal consultation. (See for example the detailed consultation undertaken by the Australian Government by comparison.) The current consultation document does not make up for that. It is likely that implementation of the MLI will therefore be a "fait accompli".

We acknowledge that wider consultation may not have altered the decision (see our comments regarding global citizenship below) but such consultation is likely to have made the consequences of signing up to the MLI more transparent.

Inconsistency of "global citizen" approach

We understand the driver for New Zealand signing up to the MLI is to show it is a good global citizen to the OECD. Applying the global consensus, as articulated by the OECD's BEPS Action plans, is required for this. This is not a completely altruistic position as it is expected that applying the global consensus will have beneficial effects for New Zealand's tax system. (See the draft International Tax Strategy.)

However, at the same time, through the deemed Permanent Establishment ("PE") and interest rate limitation proposals, New Zealand is proposing to depart from the global consensus.

The deemed PE rule is labelled as such but its features are the same as parts of the United Kingdom's Diverted Profits Tax and Australia's Multinational Anti-Avoidance rules. Both have been criticised as departures from the global consensus, which is to amend DTAs through the PE changes to be made by the MLI. The interest rate cap proposal is inconsistent with the global transfer pricing rules.

While we will be submitting in detail on the deemed PE and interest limitation issues, as a point of principle, this departure makes New Zealand's policy contradictory and incoherent. That alone should give New Zealand pause for proceeding with those proposals.

Impact of non-acceptance of the MLI PE changes on the deemed PE proposals

The deemed PE rule is supported as an anti-avoidance rule. Specifically, as an anti-DTA PE avoidance rule.

As proposed (acknowledging that the proposal does not provide the legislative detail), PE avoidance is deemed to arise if certain features exist rather than applying a DTA PE avoidance test. The proposal is drafted in this way because an anti-avoidance rule overrides a DTA.

The effectiveness of this approach is doubtful if the country or jurisdiction of the non-resident does not agree to the PE changes in the MLI. Briefly, the argument is:

— The MLI provides all countries with the opportunity to modify the PE rules in their DTAs to meet the BEPS PE concerns.

— If a country does not agree to those changes, the PE rules agreed between that country and New Zealand will not be modified. The other country does not therefore accept that New Zealand has the right to tax where the proposed deemed PE rule would apply. (Equally, it also accepts that it does not have the right to tax for activities of New Zealand residents within the BEPS PE definition.)

— Given the lack of agreement, it seems to us that characterising the deemed PE proposals as an anti-avoidance rule (so that it can override a DTA) is mere labelling. Substantively, it is not an anti-avoidance rule as, using the domestic test, it cannot be contemplated that the two parties considered that the structure should not benefit from the DTA. The lack of a change to the DTA in fact supports the view that the parties continue to contemplate that the structure is effective.

— The relevant DTA may therefore still apply despite the deemed PE rule applying on its face.

(We further note that the relevant structure may impact a number of countries. The argument that New Zealand tax is not a purpose of the structure may also be made.)

We can see no indication that this concern has been addressed. In our view, the impact on the deemed PE proposals of a DTA partner country not accepting the MLI's PE proposals needs to be carefully considered.

The lack of a principled approach by the OECD means over-taxation concerns are not addressed

In our submissions on the anti-hybrid mismatch proposals, we described the OECD's recommendations as "unprincipled". We noted that this was arguably necessary as a principled approach would have required a global consensus on the debt/equity and transparent/opaque treatment of instruments and entities. his unprincipled approach raises potential double taxation and inappropriate taxation problems.

A similar problem of an unprincipled approach arises with the MLI. It does not require all matters to be agreed, nor does it provide support for taxpayers seeking to apply an appropriate DTA.

Mutual Agreement Procedures ("MAP")

The MLI does not require mandatory arbitration by parties agreeing to other changes to their DTA. This leaves open the possibility that "bad faith" adjustments will be made by a country. This will leave taxpayers, who may otherwise accept the change in the global approach to taxing cross-border transactions, with the prospect of double taxation with no ready mechanism to fix the problem.

The simple (albeit probably naïve) response to constitutional concerns regarding the MAP is that if a country has:

— Signed up to a DTA; and

— Applies the DTA consistent with its agreements; then

— Arbitration should be of no concern as the arbitration should confirm their position.

New Zealand should require agreement to the MAP as a condition of a DTA becoming a "covered tax agreement" under the MLI.

Providing greater certainty of application of a DTA

Taxpayers experience difficulties in having other jurisdictions apply their DTA with New Zealand. This may be:

— As simple as the other country requiring forms and certifications to allow relief under the DTA to be claimed.

— As a result of differences in view of the status of a taxpayer. For example, whether a PIE or a "look through" entity is a New Zealand tax resident.

— By not applying a DTA in the way intended (e.g. to allow foreign tax credits where New Zealand has the right to tax).

We note that both US FATCA and the OECD's Automatic Exchange of Information ("AEOI") impose significant compliance obligations on New Zealand financial institutions. They do and will provide information to overseas jurisdictions of the activity of their residents in New Zealand. This should reduce the concern that New Zealand is being used as a conduit to inappropriately access DTAs.

In our view, New Zealand would be justified in making the application of the MLI to a particular DTA conditional on acceptance that New Zealand taxpayers include:

- PIEs and KiwiSaver schemes;
- Confirmation that a look through entity is also entitled to DTA relief.

Domestic impact of the MLI

The MLI will allow other countries to tax New Zealand connected activities where that would not currently be the case. This has the potential for double taxation because:

- New Zealand does not allow, or does not clearly allow, a foreign tax credit; and
- New Zealand does not allow a foreign tax credit for foreign tax which is paid indirectly.

The domestic foreign tax credit rules should be considered to ensure that foreign tax paid is available as a credit. The situations which should be considered include:

- A non-resident with New Zealand connected activity deriving foreign sourced income from that activity;
- Foreign income derived through intermediate entities;
- Taxes applied for investments in foreign companies, for which Foreign Investment Fund income is calculated under the Fair Dividend Rate method.

Further, the policy position that foreign tax credits should not be available for foreign income derived indirectly should be revisited.

Difficulty of determining the effect of the MLI and policy publications

New Zealand has not advised the countries it expects will agree to New Zealand's DTAs being covered tax agreements. Nor has it advised particular countries' positions on particular provisions of the MLI.

This makes it difficult to assess the impact of the MLI. This applies to the tax effects as well as to determining technical problems that may arise (see the deemed PE comments as a potential technical issue.)

Assuming that New Zealand will continue with its signalled approach, we consider that New Zealand should:

- Publish detailed commentary on its view of the effect of the MLI on covered tax agreements and the agreed modifications as soon as possible after a DTA partner country signs the MLI. This will be important to answer questions on the effect for a particular DTA. We note that New Zealand's DTA commentary is often very poor compared to those produced by the DTA counter-party. This means that the other country's position becomes the de facto explanation of the DTA and the reasons for the agreements made.
- Publish commentary on why particular DTAs are not covered tax agreements. For example, either New Zealand or the other country may prefer a bi-lateral negotiation (for whatever reason). This is important to answer questions regarding other BEPS proposals.
- Publish a consolidated version of the DTA which includes the agreed MLI amendments. This should be something that New Zealand does officially so that there is confidence in the versions which are published.

Specific MLI provisions

It was not apparent from the issues paper that the application of the specific MLI articles is being consulted upon. We have made some comments and submissions on some of the MLI's proposals. We are aware that others will or have made submissions on specific articles. We would be happy to discuss the specific articles with you.

Conclusion

The MLI will significantly change New Zealand's approach to taxing cross-border transactions. It will allow New Zealand to tax certain transactions that it cannot currently while allowing other countries to tax New Zealand residents on certain transactions that they currently cannot.

Although the timetable is very tight (given a June signing), New Zealand needs to be clear that the MLI will achieve its desired effect. That will to a large extent depend on other countries being willing to sign the MLI and to accept positions consistent with New Zealand's position.

To the extent there is agreement, the position should be clearer. However, that will not be the case if there is no agreement. New Zealand needs to be ready to clearly state its position for those DTAs which are not affected.

We would be happy to discuss our submissions with you should that be helpful. Our contact numbers are 04 816 4518 (John Cantin) and 09 367 5940 (Darshana Elwela).

Yours sincerely

John Cantin
Partner

Yours sincerely

Darshana Elwela
National Tax Director

Corporate Taxpayers Group

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7 April 2017

New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*
C-/ Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Cath

NEW ZEALAND'S IMPLEMENTATION OF THE MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BEPS

The Corporate Taxpayers Group ("the Group") is writing to submit on the Officials' Issues Paper "New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*" (the "Issues Paper"). The Group appreciates the opportunity to submit on the Issues Paper and looks forward to further discussing the issues with officials.

Summary of our submission

The key points in our submission are:

- The Group is concerned that the MLI will see an unnecessary increase in complexity and compliance costs. As with all tax policy proposals, the Group believes that the adoption of the MLI needs to be considered in the context of the overall impact to the New Zealand economy and "NZ Inc.". This includes consideration of tax take, attractiveness of New Zealand as an investment destination and the ease of doing business in New Zealand. New Zealand enjoys a sought after reputation as being an easy country to do business with and undertake business in. It is paramount that this reputation is protected.

- The Group does not support New Zealand's adoption of all the substantive provisions in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (the multilateral instrument or "MLI") as is proposed in the Appendix to the Issues Paper. Most of the proposed provisions are not minimum standards (i.e., there is no requirement that they be adopted), and in some cases the costs to New Zealand of including the provision in its Double Tax Agreements ("DTAs") would outweigh the benefit. We have (in Appendix Two to this letter) replicated the Appendix to the Issues Paper and summarised the Group's submissions on whether New Zealand should adopt each measure. Set out immediately below is an overview of the Group's submissions. Detailed comments expanding on the overview are set out in Appendix One.

Contact the CTG:
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- The Group considers that its measures should be adopted by New Zealand only if they will be in New Zealand's national interest. Where proposals replicate existing anti-abuse measures (thereby increasing compliance costs, but without achieving a corresponding benefit), the Group does not consider that these measures should be adopted.

Dual resident entities

- The Group does not support replacing the existing dual resident entity tie breaker provisions with a default rule that dual resident entities do not qualify for DTA relief unless the Competent Authorities agree. This amendment would not be in New Zealand's national interest. The mischief that the proposed rule targets is addressed by existing rules (and will be further addressed by the anti-avoidance provisions in the MLI). The proposed rule would, however, result in increased costs and uncertainty (and potentially double taxation) for companies that inadvertently become dual resident.

- If the amendments to the dual resident entity tie breaker provision are adopted, Inland Revenue should publish guidance on the Competent Authority process (including as to how New Zealand would apply that guidance in seeking to agree with the other affected country where a company will be resident for the purposes of the DTA). In addition, at least in the case of Australia (given the likelihood that most dual residence cases could be expected to arise between New Zealand and Australia) there should be a stream-lined application process or a self-assessment option based on published criteria for resolving dual residence cases.

Anti-avoidance provisions

- The Group acknowledges that the treaty anti-abuse rules in Article 7 of the MLI are a minimum standard and will therefore be adopted with the MLI. The Group does, however, consider that changes need to be made to New Zealand's domestic law to reduce overlap and the possibility of parallel proceedings being brought under both a DTA and the domestic law general anti-avoidance rule ("GAAR").

- The Group does not support the adoption of the dividend transfer transactions article (Article 8) of the MLI. This rule will cause administrative complexity for Inland Revenue and taxpayers. The Group considers that cases of manipulation of a shareholder's ownership interest to secure DTA relief can be addressed under Article 7 of the MLI. Article 8 would therefore add considerably to compliance costs for little, if any, benefit.

- The Group does not support the adoption of Article 9 of the MLI concerning land rich companies. As with Article 8, Article 9 would add considerably to compliance costs in circumstances where the cases in which it is intended to apply can be addressed by Article 7. In the alternative to our submission that Article 9 should not be adopted, if it is adopted, New Zealand should implement domestic law measures to reduce the additional compliance costs that will result (eg, by allowing quarterly asset values to be taken as representative of the asset values for each day in that quarter).

Artificial permanent establishment avoidance

- The Group submits that greater uncertainty will result from the expanded permanent establishment ("PE") definitions included in both the MLI and domestic law (see the proposed domestic law amendments in the Government discussion document "*BEPS — Transfer pricing and permanent establishment avoidance*"). The proposed domestic law PE rule should not apply in cases in which an arrangement is subject to (but not caught by) the broader PE definition (resulting from Part IV of the MLI) or the anti-abuse provisions in Part III of the MLI.

Dispute resolution

- The Group generally supports the amendments to the mutual agreement procedure ("MAP") and the provision for arbitration for cases not resolved by negotiation between the Competent Authorities. In order to make the amendments meaningful:

    - cases involving section BG 1 of the Income Tax Act 2007 ("ITA") should not be excluded from MAP and arbitration. To do so would effectively enable a country with a GAAR that is excluded from MAP and arbitration to also exclude from MAP and arbitration the extensive anti-abuse provisions included in the DTA, which would considerably weaken the DTA dispute resolution process; and

    - the Government should ensure that Inland Revenue is sufficiently resourced to meet the additional demands on its Competent Authority personnel that will result from the MLI.

Other matters

- Inland Revenue should publish on its website consolidated versions of each Covered Tax Agreement. Inland Revenue's compliance model is intended to be customer centric and to aid taxpayers in getting it right, first time. As such, Inland Revenue should invest the necessary resource to make consolidated versions of each Covered Tax Agreement available to all taxpayers.

- Inland Revenue should maintain a list on its website of "entry into effect for specific taxes" for each New Zealand Covered Tax Agreement so that taxpayers can easily determine from when a Covered Tax Agreement has been modified and the effective date of amendments to particular provisions.

Please contact us if you wish to discuss any of the matters raised in our submission.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ Bank New Zealand
5. ASB Bank Limited
6. Auckland International Airport Limited
7. Bank of New Zealand
8. Chorus Limited
9. Contact Energy Limited
10. Downer New Zealand Limited
11. Fisher & Paykel Healthcare Limited
12. Fletcher Building Limited
13. Fonterra Cooperative Group Limited
14. Genesis Energy Limited
15. IAG New Zealand Limited
16. Infratil Limited
17. Lion Pty Limited
18. Meridian Energy
19. Methanex New Zealand Limited
20. New Zealand Post Limited
21. New Zealand Racing Board
22. New Zealand Steel Limited
23. New Zealand Superannuation Fund
24. Opus International Consultants Limited
25. Origin Energy New Zealand Limited
26. Pacific Aluminium (New Zealand) Limited
27. Powerco Limited
28. Shell New Zealand (2011) Limited
29. SKYCITY Entertainment Group Limited
30. Sky Network Television Limited
31. Spark New Zealand Limited
32. Summerset Group Holdings Limited
33. Suncorp New Zealand
34. T & G Global Limited
35. The Todd Corporation Limited
36. Vodafone New Zealand Limited
37. Watercare Services Limited
38. Westpac New Zealand Limited
39. Z Energy Limited
40. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE: DETAILED SUBMISSION POINTS

1. General comments

1.1 The Group is concerned that the MLI will see an unnecessary increase in complexity and compliance costs. As with all tax policy proposals, the Group believes that the adoption of the MLI needs to be considered in the context of the overall impact to the New Zealand economy and "NZ Inc.". This includes consideration of tax take, attractiveness of New Zealand as an investment destination and the ease of doing business in New Zealand. New Zealand enjoys a sought after reputation as being an easy country to do business with and undertake business in. It is paramount that this reputation is protected.

1.2 The Group considers that its measures should be adopted by New Zealand only if they will be in New Zealand's national interest. Where proposals replicate existing anti-abuse measures (thereby increasing compliance costs, but without achieving a corresponding benefit), the Group does not consider that these measures should be adopted. It is with this background that the Group makes the following submissions.

2. Changes to rules for determining residence OF (and DTA benefits available to) a dual resident entity (Article 4)

Proposal is based on an incorrect assumption as to how cases of dual residence may arise

2.1 The Issues Paper proposes to replace tie breaker provisions in existing DTAs with a provision requiring the Competent Authority of each state in which the dual resident entity is resident, to "endeavour to determine by mutual agreement" in which state the entity will be deemed to be resident for the purpose of the DTA.[1] The Group considers that this measure would reduce certainty, impose additional compliance costs and increase the risk of double taxation for New Zealand businesses in circumstances where the dual residence often results from inadvertence and does not secure a tax benefit.

2.2 The changes to the dual resident entity tie breaker test are predicated on the assumption that cases of dual residence often involve tax avoidance.[2] This assumption is not reflective of the reality, at least in New Zealand. Cases of dual residence more commonly arise due to inadvertence or unavoidable changes in circumstances; in fact, so far as tax planning is concerned, the usual practice is for companies to plan not to be dual resident.

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1 The Issues Paper at page 15, in discussing the effect of Article 4 of the MLI and the consequences of the Competent Authorities agreeing tax residence, states that "[t]he proposed provision will require [Competent Authorities] to agree the residence status of a [dual resident entity] **and** the [dual resident entity] will only be entitled to such treaty benefits as the CAs agree" [emphasis added]. This might be interpreted as suggesting that the Competent Authorities must first agree whether the dual resident should be deemed resident (for DTA purposes) in one or other country and then decide which treaty benefits will be allowed as a result of that residence status. This should be clarified in future Inland Revenue statements so it is clear that if the Competent Authorities agree that the dual resident is resident in a given country for DTA purposes, relief under the DTA is allowed accordingly, and only in cases where they do not so agree will it be necessary for them to determine to what extent, if any, DTA relief should be allowed. The necessary clarification could be achieved by replacing "and" (where emphasised in the quote from the Issues Paper above) with "or".

2 OECD, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: Final Report" (OECD Publishing, Paris, 2015) at [47] (page 72). The Report states that the view of many countries was that "cases where a company is a dual-resident often involve tax avoidance arrangements".

2.3 A typical scenario in which dual residence could arise due to inadvertence could involve an Australian incorporated subsidiary ("Aus. Co") of a New Zealand resident company ("NZ Co"). Aus. Co is intended to be tax resident solely in Australia, and so it holds its directors' meetings in Australia and has its senior executives located in (and making management decisions in) Australia. Subsequently, however, directors of Aus. Co who are based in New Zealand make strategic and management decisions for Aus. Co without formal directors' meetings being convened in Australia. This results in Aus. Co being resident in New Zealand under section YD 2(1)(d) of the ITA because "its directors… exercise control of [Aus. Co] in New Zealand, even if the directors' decision-making also occurs outside New Zealand" (i.e., it is enough that some decision-making at director level occurs in New Zealand for the company to be deemed tax resident in New Zealand). The entity is therefore dual resident (in Australia due to incorporation and in New Zealand under section YD 2(1)(d)).

2.4 Dual residence in the above example arises inadvertently. The scenario will often affect businesses expanding their operations across borders for the first time, who are not as experienced in managing cross-border tax issues. Presently, most DTAs will provide a solution; the entity will be deemed to be tax resident in the country where it has its place of effective management, and will be entitled to DTA relief on that basis. The result of the proposed rule is that entities like this Aus Co will be entitled to no DTA relief from double taxation unless the Competent Authorities of New Zealand and Australia agree otherwise.

Proposal will lead to greater uncertainty and cost and increased incidence of double taxation

2.5 Currently, most DTAs to which New Zealand is party contain a dual resident tie-breaker provision. The most common tie breaker provision, contained in both the UN Model DTA (Article 4) and OECD Model DTA (Article 4), is the place of effective management test. The place of effective management test allows a taxpayer to determine the jurisdiction in which they will be resident for the purposes of the DTA by reference to a single criterion.

2.6 This has two beneficial consequences: (i) it allows taxpayers to plan appropriately and conduct risk assessments when expanding business offshore; and (ii) taxpayers can "self-assess" their tax residence for the purposes of their tax returns and pay the right amount of tax in the right jurisdiction. The adoption of Article 4 of the MLI will make it more difficult to plan and assess the risk of a proposed expansion and will make it impossible for dual resident companies to self-assess their tax liability without first approaching the Competent Authorities.

2.7 The Group considers this unsatisfactory. The Government's Business Growth Agenda calls for opportunities for business to grow internationally by reducing domestic and offshore barriers to internationalisation.[3] The proposed amendments to the tie-breaker test seem counter-productive in this regard.

3 See Ministry of Business, Innovation and Employment "The Business Growth Agenda: Towards 2025" (Ministry of Business, Innovation and Employment, Wellington, 2015).

2.8 The uncertainty will result in additional costs for taxpayers who find themselves to be dual resident. These costs will be in the form of: (i) double taxation, and/or (ii) administrative costs in requesting the assistance of the Competent Authority. In some cases, the costs of seeking Competent Authority assistance will be such that taxpayers will instead accept the denial of DTA relief. For smaller businesses considering expanding offshore, the increased risk of double taxation will be a barrier to doing so.

2.9 Further, Inland Revenue, too, will be subject to increased uncertainty if Article 4 is adopted, and will incur increased costs due to increased demands on the Competent Authority. Competent Authorities are already under pressure to resolve disputes under the general DTA resolution process the Mutual Agreement Procedure ("MAP") process. The current average time period for resolving a MAP complaint is 20 months.[4] While the Group recognises that the provision requiring Competent Authorities to agree in cases of dual residence is not strictly the same as MAP, the statistic nonetheless indicates that any process requiring the agreement of the Competent Authorities is unlikely to be rapidly concluded, and that further adding to the responsibilities of the Competent Authorities could result in longer timeframes generally.

The mischief is addressed by other measures

2.10 Considering the complexity of the amendments and the extra burden that would be imposed on Inland Revenue and taxpayers, the Group considers it important to identify the mischief that the proposed rule is designed to prevent, and consider whether that mischief is sufficiently problematic to justify the increased cost and compliance costs. On this basis, the Group considers that the proposal does not pass the cost-benefit test and so is not in New Zealand's national interest.

2.11 Domestic law already contains measures to prevent tax avoidance by dual resident companies. Loss offsets by a dual resident company are precluded by section IC 7 of the Income Tax Act 2007 ("ITA") and the consolidation rules in section FM 31(1)(e) of the ITA preclude a dual resident company from joining a consolidated group (an alternative mechanism to offset losses). The anti-hybrid proposals also include measures to prevent double deductions and other hybrid mismatches stemming from hybrid mismatch arrangements. The Group submits therefore, that the mischief the proposed rule is trying to address is already addressed by other provisions of New Zealand's domestic law and by other proposals under consideration and should not be introduced into New Zealand's DTA network.

2.12 Further, the MLI will introduce broadly worded anti-abuse provisions into DTAs to which the MLI applies. This will mean that within the DTA itself, as well as under domestic law, there will be provisions to address any cases in which dual resident companies are being used to secure DTA relief in inappropriate circumstances.

4 See OECD "Mutual Agreement Procedure Statistics for 2015" http://www.oecd.org/tax/dispute/map-statistics-2015.htm (accessed 29 March 2017).

Alternative submission: proposed solution if the dual resident tie breaker amendment is adopted

2.13 If the Government nevertheless considers it necessary to adopt the proposed rule, the Group proposes the following suggestions with a view to reducing the cost and uncertainty that will result:

(a) Inland Revenue should issue guidance to taxpayers setting out New Zealand's position as to when the New Zealand Competent Authority would consider an entity should be tie-broken into one or other country (ie, what are the factors that the New Zealand Competent Authority would consider when negotiating with other Competent Authorities on the question of where a dual resident entity should be agreed to be resident).

(b) For states with which New Zealand has significant trading relations and in respect of which taxpayers are at greatest risk of becoming dual resident (eg, Australia), Inland Revenue should seek to negotiate a formal, public MAP decision which will set out the criteria by which dual resident entities can "self-assess" residence without having to be subject to double taxation or incur the costs of requesting Competent Authority assistance. The Group would be happy to discuss this proposal further with officials.

3. Treaty anti-abuse rules

Overview

3.1 The treaty anti-abuse rules in Article 7 of the MLI are a minimum standard. Of the three options available under the MLI, the principal purpose test ("PPT") appears to the Group to be most in keeping with New Zealand's existing DTA practice and domestic law. The Group therefore accepts the appropriateness of New Zealand opting for the PPT test in Covered Tax Agreements.

3.2 The Group is concerned, however, that given the multiple layers of anti-avoidance measures being proposed, much greater uncertainty for taxpayers could result, for no demonstrable benefit for New Zealand. The Group's submissions that follow therefore suggest a rationalisation of the potential multiple layers of anti-abuse rules introduced in the MLI, and guidance as to the relationship between the PPT that will be introduced by the MLI and the domestic law general anti-avoidance rule ("GAAR") in section BG 1 of the ITA.

Dividend transfer transactions (Article 8)

3.3 The Group does not support the adoption of the dividend transfer transactions article (Article 8) of the MLI. This 365-day ownership requirement will cause administrative complexity for Inland Revenue and taxpayers. Any cases of manipulation of a shareholder's ownership interest to secure DTA relief can be addressed under Article 7 of the MLI. Article 8 would therefore add considerably to compliance costs for little, if any, benefit.

3.4 In the alternative to our submission above that Article 8 should not be adopted, if Article 8 is adopted, Inland Revenue should release guidance as to how the rule will work in practice and should consider domestic law amendments to facilitate compliance with Article 8. In particular, is it intended that the shareholder receive the benefit of the lower withholding rate at source only if it has already held the required shareholding for 365 days before the dividend is paid? In that case, where the higher rate is applied and the shareholder subsequently passes the 365-day period, the shareholder would need to seek a refund of over-deducted tax. Alternatively, can a company, when paying a dividend, rely on a representation that the shareholder intends to hold the interest for 365 days? In that case, any additional source country tax payable by the shareholder should the shareholder not hold the required interest for the full 365-day period should be the responsibility of the shareholder, not of the company that has paid the dividend.

3.5 The administrative complexities associated with the proposed rule demonstrate the merit in our primary submission. That is, in view of the wide reaching PPT test, any benefit in adopting the rule is outweighed by the costs, such that it should not be adopted by New Zealand.

Land rich company rules (Article 9)

3.6 The land rich company test (eg, whether more than 50% of the value of shares in the company is derived from real property) is intended to permit a source country to tax gains on the disposal of shares in a company the value of which is mainly attributable to land situated in the source country. The proposal is that a land rich test be required to be applied on each day of the 365-day period preceding a disposal to which the alienation of property article in the DTA might apply. The concern apparently underlying Article 9 is that the company's assets can be manipulated prior to a disposal of its shares so the value of real property falls below the threshold (say 50%).

3.7 The Group does not support the adoption of the rule in Article 9 of the MLI. As with Article 8, Article 9 would add to compliance costs in circumstances where the scenarios in which it is intended to apply can be addressed by Article 7.

3.8 In the alternative to our submission that Article 9 should not be adopted, if it is adopted, New Zealand should implement domestic law measures to reduce the additional compliance costs that will result (eg, by allowing quarterly asset values to be taken as representative of the asset values for each day in that quarter).

Guidance as to the relationship between the PPT and section BG 1 of the ITA

3.9 Recent amendments to section BH 1 of the ITA provide that (in contrast to the usual position, that a DTA has effect despite anything in the ITA) a DTA (including its dispute resolution provisions) will not override section BG 1. Yet the MLI would introduce to Covered Tax Agreements a PPT which on the face of it is intended to operate as the DTA equivalent of section BG 1.

3.10 This layering of anti-avoidance provisions (one regime (the PPT) contained in the DTA, and a second (section BG 1) contained in domestic law and expressed to override the DTA) will be problematic. Countries party to a DTA which incorporates the PPT could reasonably expect that the PPT should be the reference point for determining whether an arrangement should be considered abusive such that DTA relief otherwise available should be denied. If a taxpayer satisfies (ie, is not caught by) the very broad PPT in a Covered Tax Agreement, it would be reasonable for that taxpayer to conclude that DTA relief should not then be denied unilaterally by New Zealand under section BG 1, the domestic law counterpart to the DTA's PPT.

3.11 The correct policy result is that if a taxpayer satisfies (ie, is not caught by) the PPT in a Covered Tax Agreement, it should not be open for Inland Revenue to invoke section BG 1 to unilaterally deny DTA relief otherwise available. This could be achieved by:

(a) amending section BH 1(4) so that the reference to section BG 1 applies "other than in the case of a double tax agreement that contains or is subject to Article 7 of the MLI or an anti-abuse rule substantially similar to Article 7 of the MLI"; and/or

(b) Inland Revenue issuing guidance (in the form of a Standard Practice Statement) to the effect that Inland Revenue will not invoke section BG 1 to deny DTA relief otherwise available to a taxpayer if the DTA contains or is subject to Article 7 of the MLI or an anti-abuse rule substantially similar to Article 7 of the MLI.

4. Preventing the artificial avoidance of permanent establishment status

4.1 The Group is concerned by the uncertainty (and increased risk of double taxation) that will result from layers of rules intended to extend the reach of the PE definition. For some DTAs, the MLI amendments may apply, and in respect of all DTAs, the separately proposed domestic law PE avoidance rule could apply.

4.2 Further consideration should be given to the relationship between these measures and to the uncertainty that will result from multiple layers of rules with the same broad objective. The Group submits that Inland Revenue should include a provision in the proposed domestic PE avoidance rule confirming that if an entity does not have a PE under the provisions of a DTA containing the expanded PE definition (Part IV of the MLI) read with the anti-abuse provisions in Part III of the MLI, then the domestic law PE avoidance rule will not apply.

5. Improved mechanism for effective dispute resolution

Greater resourcing will be required to meet the increase in cases requiring Competent Authority involvement

5.1 The Group supports the amendments to MAP and the inclusion of arbitration. But for the improvements to dispute resolution to be meaningful, the Government must ensure that the Competent Authority is sufficiently resourced to meet the expected increase in cases requiring Competent Authority determination, and/or which are referred to MAP and arbitration.

GAAR should not be excluded from arbitration

5.2 The Group also submits that cases involving the GAAR should not be excluded from the arbitration process. The introduction of the PPT will mean that affected DTAs will have embedded in them very similar concepts to the concepts underlying the GAAR. (See further the discussion at paragraphs 3.9 to 3.11 above.) Accordingly, the correct policy outcome is that any disputed denial of DTA relief, whether in reliance on the PPT (in the DTA) or in reliance on the GAAR, should be subject to the same disputes resolution process in the DTA.

5.3 The OECD appears to have recognised the same point in its BEPS Action 14 Final Report, in recommending that whether DTA relief should be denied (whether under a DTA or a domestic law anti-abuse provision) should not be for one country to determine unilaterally, but rather should be able to be referred to MAP:[5]

> *Countries should provide MAP access in cases in which there is a disagreement between the taxpayer and the tax authorities making the adjustment* ***as to whether the conditions for the application of a treaty anti-abuse provision have been met or as to whether the application of a domestic law anti-abuse provision is in conflict with the provisions of a treaty****.*
> [Emphasis added]

5.4 If the GAAR is excluded from arbitration, any dispute as to the application of a DTA which raises questions under a PPT could likewise be excluded from arbitration, since Inland Revenue could be expected to invoke the GAAR in parallel with the PPT. This would materially limit the value of the arbitration provision, and lead to disputes being pursued through parallel processes (some issues via MAP and arbitration, and some via the courts). Further, to exclude consideration of the GAAR from arbitration would significantly diminish the utility of MAP, since arbitration is in effect an enhancement to MAP, providing increased assurance the MAP will lead to an outcome.

5.5 Excluding the GAAR from the provisions of MAP and arbitration is, in the Group's view, contrary to the purpose of MAP and arbitration as an alternative dispute resolution process. The BEPS Action 14 Final Report emphasised that the MAP was to provide a disputes resolution process which was an alternative to and "independent from the ordinary legal remedies available under domestic law".[6]

5.6 Many states will require that domestic law processes be stayed before they will consider a MAP complaint. If Inland Revenue invokes the GAAR in parallel with invoking the PPT, and the GAAR question cannot be subject to MAP and arbitration, then the domestic law proceedings may not be stayed, further complicating the taxpayer's access to MAP and arbitration on other issues.

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5 OECD "Making Dispute Resolution Mechanisms More Effective, Action 14: Final Report" (OECD Publishing, Paris, 2015) at recommendation 1.2 [emphasis added].

6 OECD "Making Dispute Resolution Mechanisms More Effective, Action 14: Final Report" (OECD Publishing, Paris, 2015) at [10].

5.7 Finally, to exclude the GAAR from arbitration raises the prospect that New Zealand and other countries might be able to tactically invoke the GAAR as a means of preventing the taxpayer from accessing MAP and arbitration in the very cases in which those processes may be of most value to the taxpayer. This would leave the taxpayer, in such cases, without access to MAP (a process which the OECD has described as being "of fundamental importance to the proper application and interpretation of the [DTA]").[7] It would also mark a less cooperative (and more unilateral) approach to international base erosion and profit-shifting concerns, in contrast to the cooperative approach New Zealand has supported to date.

6. Other matters

6.1 Inland Revenue should publish on its website consolidated versions of each Covered Tax Agreement. This would be consistent with Inland Revenue's compliance model which is intended to be customer centric and to assist taxpayers in getting it right. Taxpayers should have equal access to DTAs and should not need to pay for copies in an easy to understand format or to rely on commercial publishers to make consolidated versions available

6.2 Inland Revenue should maintain a list on its website of "entry into effect " for each New Zealand Covered Tax Agreement so that taxpayers can easily determine the effective date(s) of the application of the MLI for a Covered Tax Agreement.

[7] OECD "Making Dispute Resolution Mechanisms More Effective, Action 14: Final Report" (OECD Publishing, Paris, 2015) at [10].

APPENDIX TWO: SUBSTANTIVE BEPS PROVISIONS IN THE MULTILATERAL INSTRUMENT AND CTG COMMENTS

BEPS measure	Detail	Minimum standard	Should NZ adopt?	CTG Comment
1. Neutralising the effects of hybrid mismatch arrangements that have a treaty aspect **(Action 2 report)**	**Fiscally transparent entities** The MLI introduces or amends a fiscally transparent entity (FTE) provision. FTEs (like trusts or partnerships) create arbitrage opportunities because they are treated differently for tax purposes by different countries. The MLI provision clarifies that treaty benefits will only be allowed to the extent to which the item of income is taxed in the state in which the entity is resident. New Zealand already includes this provision (or an equivalent provision) in its DTAs with Australia, United States, Chile and Japan. *Article 3 of the MLI*	No	Yes	–
	Dual resident entities The MLI introduces or amends a dual resident entity (DRE) tie breaker provision. Like FTEs, DREs can be used to take advantage of arbitrage opportunities. The proposed provision will require CAs to agree the residence status of a DRE and the DRE will only be entitled to such treaty benefits as the CAs agree. *Article 4 of the MLI*	No	Yes	The Group does not think this article should be adopted as it will increase instances of double taxation and compliance costs and other measures address the perceived mischief.
	Relief of double taxation The MLI allows countries to strengthen their application of the exemption method to relieve double taxation. New Zealand already applies the (more robust) credit method in all of its DTAs, and therefore proposes not to adopt any of the options. *Article 5 of the MLI*	No	Not applicable	The Group agrees that this article is not applicable to New Zealand network of DTAs
2. Preventing the granting of treaty benefits in inappropriate circumstances	**Preamble language – minimum standard** The MLI will amend the preamble to DTAs to emphasise that as well as aiming to relieve double taxation, the treaty also aims to prevent opportunities for non-taxation, reduced taxation or tax avoidance. *Article 6(1) and (2) of the MLI*	Yes	Yes	–

BEPS measure	Detail	Minimum standard	Should NZ adopt?	CTG Comment
(Action 6 report)	**Preamble language – optional amendment** The MLI allows countries to adopt the following optional amendment to the preamble to DTAs: "Desiring to further develop their economic relationship and to enhance their co-operation in tax matters," *Article 6(3) and (6) of the MLI*	No	Yes	—
	Treaty anti-abuse rules The MLI requires jurisdictions to introduce an anti-abuse rule into DTAs. Jurisdictions can meet this minimum requirement in one of three ways: 1. a principal purpose test (PPT) alone; 2. a PPT plus a "simplified limitation on benefits" (LOB) clause. The LOB is a mechanical provision that seeks to identify, through a series of black-letter tests, whether a person is genuinely entitled to the benefits of a DTA; or 3. enter into bilateral negotiations to include a detailed LOB provision plus a PPT or anti-conduit rules. In the case of New Zealand, officials' favour adopting a PPT alone. The PPT is very similar to New Zealand's domestic law GAAR and will deny treaty benefits if the principal purpose of an arrangement was to secure those benefits. Also, in officials' view, it generally covers the same treaty shopping issues as the alternative approaches. *Article 7 of the MLI*	Yes	Yes	The Group acknowledges that the anti-abuse rules are a minimum standard and will be adopted with the MLI. The Group does consider however, that the domestic law amendments and/or guidance may be required to provide for the relationship between the PPT and GAAR.
	Dividend transfer transactions The MLI introduces a provision that requires shares to be held for a minimum of 365 days for the shareholder to be entitled to the reduced withholding tax (WHT) rates on dividends. This is to stop shareholders buying shares temporarily to access the reduced WHT rates and then immediately selling them. *Article 8 of the MLI*	No	Yes	The Group does not consider this amendment is necessary in light of the adoption of the PPT and the increased complexity and costs it will lead to.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	CTG Comment
	Land rich company rules The MLI introduces a treaty provision that strengthens the anti-abuse "land-rich company" test (land rich companies are companies whose assets are mainly land). Some treaties do not contain this provision at all, so the MLI also allows it to be inserted into those treaties. The new rule reinforces the position that the source jurisdiction can tax land held by non-resident owners in the other jurisdiction through corporate vehicles. To prevent artificial and temporary dilution of the amount of land held by a company just before sale, the MLI provision requires the threshold for the amount of land ownership which triggers the rule to be measured on every day in the 365 day period leading up to the sale of the shares. The MLI provision also ensures the same rule applies to other investment vehicles such as partnerships and trusts. *Article 9 of the MLI*	No	Yes	The Group does not consider this amendment is necessary in light of the adoption of the PPT and the increased complexity and costs it will lead to. Alternatively, if this article is adopted, the Group proposes that provisions should be provided in domestic law to ensure that compliance costs are reduced.
	Third-state PE rules The MLI introduces a treaty provision that denies treaty benefits in the case of income derived by a PE of a resident of one of the parties to the DTA, where that PE is situated in a low tax third-state. *Article 10 of the MLI*	No	Yes	—
	Right to tax own residents The MLI introduces a provision that preserves a jurisdiction's right to tax its own residents (for example, this prevents New Zealand residents engaged in a tax avoidance arrangement claiming a DTA prevents New Zealand from using the domestic law GAAR to impose tax). *Article 11 of the MLI*	No	Yes	—

BEPS measure	Detail	Minimum standard	Should NZ adopt?	CTG Comment
3. Preventing the artificial avoidance of PE status	**Commissionaire arrangements and similar strategies** Currently, a number of artificial structures including the civil law concept of a "commissionaire" can be used to avoid having a PE in a jurisdiction. A new provision will deem non-residents using these structures to have a PE in the jurisdiction. *Articles 12 and 15 of the MLI*	No	Yes	—
	Specific activity exemptions – preparatory and auxiliary qualification Certain specific activities carried on in a jurisdiction are deemed **not** to constitute a PE (for example, premises used for simply storing goods or stock maintained for display or delivery). These specific carve-outs from the PE definition allowed quite substantial economic activities to fall within them. The MLI proposes clarifying that the specific carve-outs listed in the DTA must be subject to an additional requirement that they be "preparatory and auxiliary" in nature. There are two options for dealing with this issues – Option A (which New Zealand favours) which subjects all of the existing specific activities to an explicit "preparatory and auxiliary" test, and Option B, which does not subject the specific activities to the "preparatory and auxiliary" test (because these activities are considered to be inherently preparatory and auxiliary in nature), but subjects any other activity or combination of activities to the "preparatory and auxiliary" test. *Articles 13 and 15 of the MLI*	No	Yes	—
	Specific activity exemptions – Anti-fragmentation rule The MLI introduces an "anti-fragmentation" rule that will prevent an enterprise from dividing up all of its activities so that related parties each carry on a separate part of the business (that fall within the PE exceptions), but taken together they constitute a PE. *Articles 13 and 15 of the MLI*	No	Yes	—

BEPS measure	Detail	Minimum standard	Should NZ adopt?	CTG Comment
	Anti-contract splitting rule Currently a construction, installation or building project does not constitute a PE unless it last for more 12 months. Entities were abusing this 12 month limit by having back-to-back 12 month contracts so they never exceeded the 12 month threshold. Generally the contracts were undertaken by different companies within the same group of companies. The new an "anti-contract splitting" rule will aggregate related projects to prevent PE avoidance. *Articles 14 and 15 of the MLI*	No	Yes	—
4. Providing improved mechanisms for effective dispute resolution	**MAP – access to the CAs of either jurisdiction** In Covered Tax Agreements that do not already have it, the MLI will introduce a provision allowing taxpayers to request mutual agreement procedure (MAP) in cases where they believe taxation is not in accordance with the treaty. If a MAP provision is already contained in a DTA, the MLI will amend it to allow taxpayers to approach the CA of *either* jurisdiction to resolve uncertainty as to how the DTA applies (New Zealand's DTAs currently contain MAP provisions, but taxpayers are only entitled to approach the CA of the jurisdiction of which they are a resident). *Article 16 of the MLI*	Yes	Yes	The Group supports the adoption of the MLI articles relating to MAP. These amendments will ensure that taxpayers have greater access to MAP.
	MAP – corresponding adjustment Requires contracting states to make appropriate corresponding adjustments in transfer pricing cases. *Article 17 of the MLI*	No	Yes	—
	Arbitration If, under the MAP process, the CAs do not agree on the correct interpretation of the DTA, the CAs can submit the matter to an independent arbitrator (or a panel of three arbitrators) for decision. The arbitrators will decide which of the CAs is correct. The CAs are generally bound by the decision of the arbitrators, but the taxpayer is not. Therefore, the taxpayer could pursue a court case if it disagrees with the arbitrators' decision.	No	Yes	The Group supports the adoption of the MLI articles relating to arbitration.

BEPS measure	Detail	Minimum standard	Should NZ adopt?	CTG Comment
	New Zealand's approach is to adopt what is referred to as "final offer" or "last best offer" arbitration (in Article 23(1)), but to accept "independent opinion" arbitration if the other party to the Covered Tax Agreement chooses this (by entering a reservation under Article 23(2)). In the case of "independent opinion" arbitration, New Zealand will adopt Article 24(2) and (3) which means that the arbitrators' decision will not be binding on the CAs if they come to an alternative resolution of all unresolved issues within 3 calendar months of the delivery of the arbitrators' decision. New Zealand also proposes to require undertakings of confidentiality by all parties involved in arbitration (Article 23(5)) and reserves the right not to include arbitration provisions in Covered Tax Agreements with jurisdictions that do not require the same (Article 23(6) and (7)). New Zealand intends to enter a free form reservation in respect to arbitration to carve out cases that involve the application of New Zealand's general anti-avoidance rule contained in section BG 1 of the Income Tax Act 2007. *Articles 18 – 26 of the MLI*			MAP and arbitration should be available as independent and alternative dispute resolution processes. Accordingly, section BG 1 should not be excluded from the scope of the arbitration provisions.

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New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

7 April 2017

Email: policy.webmaster@ird.govt.nz

Dear Sir

Submissions on New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*

We refer to the officials' issues paper, "New Zealand's implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS"*, which was released for consultation on 3 March 2017 ("IP"). We appreciate the opportunity to comment and do so below and, in more detail, in the attached Appendix.

Overall we support the implementation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* ("MLI") in New Zealand as a relatively simple way to enact various international obligations to which New Zealand has committed. We also agree that the MLI should be implemented as widely as possible, taking up minimum standards and virtually all optional articles, with few reservations.

However, there are issues which Inland Revenue should address in order to ensure the MLI is implemented in an efficient manner with minimal uncertainty and compliance costs. We respond to the specific questions posed for submission below, followed by comments on some other matters we believe require consideration.

All legislative references are to the Income Tax Act 2007 ("ITA"), unless otherwise stated.

Domestic law changes

Various amendments are required to the domestic disputes procedure rules in order for the mutual agreement procedure ("MAP") to work coherently alongside the existing domestic disputes procedure in the Tax Administration Act 1994 ("TAA"). These changes are largely required to ensure it is not necessary to invoke the domestic disputes procedure at the same time as carrying out the MAP:

- The response period in section 89AB of the TAA should either be extended or suspended when the taxpayer requests the Commissioner to invoke MAP.
- MAP could alternatively/additionally be treated as an alternative to the domestic disputes procedure.
- In the event of a taxpayer commencing MAP and a domestic dispute, the existing four year time period in section 89P of the TAA should be suspended.
- Rules regarding Commissioner initiated disputes may need amendment.
- Section 138I of the TAA should be extended to all disputed tax which is subject to MAP.
- The taxpayer right to request to opt-out of the disputes procedure should be extended to include international disputes.

Implementation

To assist with implementation:

- Inland Revenue should provide guidance on the interaction between "treaty abuse" under the MLI and "tax avoidance"/the general anti-avoidance rule ("GAAR") under section BG 1.

- We note New Zealand's intent to enter a free form reservation with respect to arbitration carve out cases that involve the application of section BG 1. Although arbitration does not have jurisdiction over section BG 1 (being a domestic law matter), it is important for arbitration to be available to resolve disputes about the application of DTAs to the (reconstructed) "facts" arising from a BG 1 / GB 1 assessment.

- DTAs currently being renegotiated should be included as Covered Tax Agreements ("CTAs").

Minimising uncertainty and compliance costs

In relation to practical options for minimising uncertainty and compliance costs:

- We anticipate an increase in the number of DTA disputes and cases of double taxation following the implementation of the MLI. Inland Revenue may need to increase the level of resources available to competent authorities in respect of MAP cases.

- Inland Revenue should consider producing consolidated Double Tax Agreement ("DTA") texts.

Other matters for consideration

- New Zealand's domestic law around the attribution of profits is likely to change as a result of BEPS initiatives. Taxpayers would likely benefit from some Inland Revenue commentary/guidance around New Zealand's approach to profit attribution given the proposed changes to the permanent establishment definition.

- The MLI may have a greater impact on New Zealand outbound investors than it does on inbound investors into New Zealand, where outbound investment is into jurisdictions with less sophisticated domestic law and DTA networks. The Government should not assume any additional net revenue as a result of the MLI.

- Further explanation is required regarding the difference in approach between Australia and New Zealand in respect of third-state permanent establishment rules (Article 10).

We would be happy to discuss any aspect of our submissions with you. Please contact David Snell (david.snell@nz.ey.com) in the first instance in that regard.

Yours faithfully

Aaron Quintal

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Ernst & Young Limited

Appendix

Amendments to disputes procedure

We submit:

- The response period in section 89AB of the TAA should either be extended or suspended when the taxpayer requests the Commissioner to invoke MAP.
- MAP could alternatively/additionally be treated as an alternative to the domestic disputes procedure.
- In the event of a taxpayer commencing MAP and a domestic dispute, the existing four year time period in section 89P of the TAA should be suspended.
- Rules regarding Commissioner initiated disputes may need amendment.
- Section 138I of the TAA should be extended to all disputed tax which is subject to MAP.
- The taxpayer right to request to opt-out of the disputes procedure should be extended to include international disputes.

Various amendments are required to the domestic disputes procedure rules in order for the MAP to work coherently alongside the existing domestic disputes procedure in the TAA.

The interrelationship between MAP and the domestic disputes procedure will be of concern to taxpayers. For instance, in the event a dispute arises over the interpretation or application of the DTA, should the taxpayer seek to apply domestic procedures or MAP? Currently these procedure are run simultaneously which can be a costly, time consuming and inefficient process for taxpayers. In our experience, this double handling has acted as a disincentive for taxpayers to initiate MAP.

Taxpayer initiated disputes

Current international tax BEPS-related proposals will increase uncertainty, and we anticipate an increase in the number of taxpayer initiated disputes. Taxpayers will be required to issue a Notice of Proposed Adjustment (“NOPA”) within the four month response period in section 89AB of the TAA, even when the subject matter of the dispute would better be resolved under the MAP.

We submit the response period in section 89AB of the TAA should either be extended or suspended when the taxpayer requests the Commissioner to invoke MAP. This change would provide sufficient time for MAP to be completed without the taxpayer incurring compliance costs in commencing a (possibly unnecessary) domestic dispute, or forfeiting the right to subsequently commence that dispute if it remains unsatisfied by the outcome of MAP.

MAP could alternatively/additionally be treated as an alternative to the domestic disputes procedure. This change would require an amendment to section 138B of the TAA to permit taxpayers to commence a challenge under Part 8A of the TAA if they have completed either:

- The domestic disputes procedure in Part 4A of the TAA, or
- MAP.

In that event, presumably the Commissioner would be required to issue a "challenge notice" to a taxpayer who had initiated MAP and remained dissatisfied with the outcome.

In the event the taxpayer also commenced a domestic dispute within the existing response period, the existing four year time limit for resolving that dispute under section 89P of the TAA will have to be suspended, as it would be difficult for the parties to have completed both MAP and then the domestic disputes procedure.

Commissioner initiated disputes

Where the Commissioner has commenced a dispute, consideration needs to be given as to:

- Whether the parties will be required to complete that dispute pursuant to s 89N of the TAA, if the dispute is also subject to MAP, or
- Will the resolution of MAP permit the Commissioner to truncate the domestic dispute?

In any of those scenarios under which the domestic disputes procedure is not completed because the MAP has been invoked, consideration will need to be given as to how the exclusion rule in section 138G of the TAA will apply to the subsequent challenge.

Deferred tax

In our view, section 138I of the TAA should be extended to all disputed tax (regardless of which party commences the dispute) where the disputed tax is the subject of MAP. There is an inconsistency in the treatment of "deferred tax" under s 138I of the TAA. That provision suspends the taxpayer's obligation to pay disputed tax until the challenge under Part 8A of the TAA is finally resolved. However, there is no comparable provision within Part 4A of the TAA suspending the obligation to pay disputed tax until the dispute (or subsequent challenge) is resolved. Where the dispute is commenced by the Commissioner, this omission has no practical effect. However, where the dispute is commenced by the taxpayer (whether by proposing an adjustment to its own conservative return or in response to an assessment issued by the Commissioner in reliance on s 89C of the TAA) the disputed tax is immediately payable.

Request to opt-out

An inherent problem with the domestic disputes procedure is the practical inability to resolve disputed facts. MAP suffers from the same failing, with other jurisdictions often having poorer fact finding processes than New Zealand. Neither MAP nor the domestic disputes will resolve a dispute involving questions of both international tax law and contested facts. Some disputes are more efficiently resolved before the courts. Accordingly, in our view, the taxpayer right to request to opt-out of the disputes procedure should be extended to include international disputes.

Interaction between "treaty abuse" under the MLI and "tax avoidance" under section BG 1 of the ITA

We submit that Inland Revenue should provide guidance on the interaction between "treaty abuse" under the MLI and "tax avoidance" / the general anti-avoidance rule ("GAAR") under section BG 1.

The MLI incorporates treaty abuse into New Zealand's DTAs, with New Zealand favouring a "principal purpose test" ("PPT") as our preferred means of meeting the minimum standard. There have also been recent amendments to section BH 1, which grants supremacy to section BG 1 over the application of DTAs.

It is not clear whether a dispute must first be resolved under section BG 1 (which, if applicable, determines the facts to which the DTA and MAP is applied) before MAP can be invoked. If not, then the basis on which the Commissioner seeks to apply MAP to the (presumably still disputed) reconstructed facts is unclear. As the Commissioner cannot unilaterally conduct MAP with the counterparty on the basis of reconstructed facts which remain in dispute, the MAP procedure can presumably either:

- Be conducted on the taxpayer's original facts (regardless of the Commissioner's allegation of avoidance) applying the PPT test, or
- Must be invoked only after the domestic dispute over section BG 1 is resolved (which given the recent amendments to section BG 1 results in the PPT test having little, if any, practical effect).

It is not clear how the different thresholds for PPT and section BG 1 co-exist. Treaty abuse arises when a principal purpose was to secure the benefits of the treaty. By comparison, domestic tax avoidance arises when the taxpayer's purpose or effect is more than merely incidental (being the statutory test) and the tax outcomes are not in accordance with the Parliamentary contemplation test (as outlined in *Ben Nevis*)[1].

[1] Ben Nevis Forestry Ventures Ltd v C of IR (2009) 24 NZTC 23,188

Although the IP states that the PPT is very similar to the domestic GAAR, the thresholds are different and there is a possibility that a taxpayer may have breached section BG1 but not guilty of treaty abuse (much as some taxpayers have been found liable for tax avoidance under section BG 1 but faced no shortfall penalty for adopting an abusive tax position under section 141D of the TAA – see for instance see *Penny & Hooper v CIR*[2] and *Glenharrow Holdings Ltd*[3]). Given the recent amendments to section BH 1, further consideration needs to be given as to whether the treaty abuse provision in the MLI is redundant.

Resourcing issues

Inland Revenue may need to increase the level of resources available to competent authorities in respect of MAP cases.

Implementation of the MLI is likely to result in an increased number of DTA disputes, and we have concerns that Inland Revenue may not have sufficient resources to deal with the increased number of disputes. Consideration should therefore be given the Inland Revenue's resourcing in this area.

Exclusion in the case of renegotiation

We submit that DTAs currently being renegotiated should be included as CTAs.

The IP states that New Zealand's general approach is to include the majority of its DTAs as CTAs. However, DTAs will be omitted where we are currently renegotiating the DTA and the other party agrees that it should not be covered because the provisions are expected to be included in the new DTA.

Given New Zealand's intent to adopt almost all provisions of the MLI across our treaty network, we assume they will represent the Government's model treaty position. Treaty negotiations can be protracted. We see no reason why DTAs currently under renegotiation should not be included as CTAs. While the renegotiated DTA will eventually override the previous DTA (as modified by the MLI), if it is expected that the provisions of the MLI will be included in the new DTA then CTA status will promote greater certainty at an earlier date. It may also allow for smoother ratification of a renegotiated treaty given that there will be fewer policy changes for Parliament to consider.

Consolidated DTA texts

We submit that Inland Revenue should consider producing consolidated DTA texts rather than requiring taxpayers to undertake a comparison with amending protocols or rely on consolidated versions produced by commercial publishers.

The IP states that the Government will not produce consolidated versions of each DTA that has been modified by the MLI (paragraph 4.18). While this approach is consistent with existing practice for amending protocols, reading a DTA that is subject to the MLI is likely to be more difficult than reading a DTA subject to an amending protocol. The IP itself notes that the MLI is of a novel nature (paragraph 1.17).

Accordingly, we believe that production of consolidated DTAs would reduce both uncertainty and compliance costs for taxpayers. While commercial publishers are likely to produce consolidated versions, we believe the significance of the MLI warrants production of authoritative consolidated versions by the Government as opposed to reliance on versions produced by others. We anticipate production will have only a marginal cost to the Government as it will already have analysed the effect of the MLI in deciding on CTA status for each treaty partner.

Effect on outbound investors

We submit that consideration needs to be given to the effect the MLI will have on New Zealand outbound investors.

[2] Penny and Hooper v Commissioner of Inland Revenue (2011) 25 NZTC 24,396 (SC)
[3] Glenharrow Holdings Ltd v Commissioner of Inland Revenue (2009) 24 NZTC 23,236 (SC)

Most of the attention around the effect of the MLI has been focused on inbound investors. We believe it is necessary to consider the impact of entering into CTAs on New Zealand outbound investors, in particular, the provisions regarding third-state permanent establishment rules and rules regarding the artificial avoidance of permanent establishment status.

New Zealand already has robust source taxation rules, strong anti-avoidance law and a comprehensive treaty network. Further changes to our domestic law regarding permanent establishments are proposed. This combination of factors means the New Zealand Government may raise relatively little revenue from inbound investors as a result of the MLI.

Outbound New Zealand investors, however, may face bigger effects. Where investment is into jurisdictions with a lesser degree of focus on permanent establishment or sourcing rules, the effect of the MLI may be to increase the taxing rights of our treaty partners, to the detriment of both outbound investors and the Government.

Anti-Abuse Rule for Permanent Establishments situated in third jurisdictions

We submit that greater explanation is required for New Zealand's decision to adopt Article 10 of the MLI regarding third-state permanent establishment rules.

Australia does not intend to adopt Article 10 pending further analysis of its potential impact in the Australian context.[4] We are not clear on the article's impact in New Zealand and would welcome greater explanation of New Zealand's position and/or an approach comparable to that of Australia.

[4] Australia's adoption of the BEPS Convention (Multilateral Instrument), Australian Government Consultation Paper, December 2016

SUBMISSIONS

BEPS – Transfer pricing and permanent establishment avoidance

Submissions received for the Government's discussion document *BEPS – Transfer pricing and permanent establishment avoidance* (March 2017).

Number	Submitter
001	KPMG
002	Oxfam New Zealand
003	New Zealand Council of Trade Unions Te Kauae Kaimahi
004	TP EQuilibrium | AustralAsia
005	Chartered Accountants Australia and New Zealand
006	Ernst & Young Limited
007	PricewaterhouseCoopers
008	AMP Capital Investors (New Zealand) Limited
009	Deloitte
010	Russell McVeagh
011	National Foreign Trade Council
012	American Chamber of Commerce in New Zealand Inc.
013	Digital Economy Group
014	Corporate Taxpayers Group
015	Deloitte
016	New Zealand Law Society

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Our ref: 10477529_1.docx

Private and confidential
BEPS – PE and transfer pricing strengthening
C/- Deputy Commissioner, Policy and Strategy
PO Box 2198
Wellington 6140

13 April 2017

Dear Madam

We have attached our submissions on the deemed PE and transfer pricing strengthening proposals.

Fairness

Our approach has been to consider whether the proposals achieve some measure of making the tax system "fair". We refer to our submissions on the Hybrids consultation where we noted that "fairness" remained undefined. We further noted the apparent reliance on a global consensus for implementing the OECD's hybrids actions.

The current document proposes a number of changes which do not apply the global consensus. It is possible that the proposals will produce an unfair result. In particular, there are opportunities for double taxation and in the context of a global allocation of taxable profits, over-taxation for the economic activity carried out in New Zealand.

Resource intensive nature of transfer pricing

We have tried to make sense of the Officials concerns regarding the resourcing requirements of transfer pricing. These are used as justification for reversing the burden of proof and increasing the statute bar period.

The current rules are:

— taxpayers document their transfer pricing in accordance with OECD guidelines and methods. If Inland Revenue disagrees with that result, Inland Revenue must prove the taxpayer is wrong. This creates work (because invariably the taxpayer disagrees).

— taxpayers do not document their transfer pricing. Inland Revenue disagrees. The onus of proof is with the taxpayer who will need to document compliance with OECD guidelines and methods. If Inland Revenue continues to disagree, Inland Revenue must do sufficient work to show the taxpayer is wrong.

The proposals will not in our view change this. If taxpayers have carried out the work, they will consider they have discharged the onus of proof. To show that is not the case, Inland Revenue will need to show why that is wrong. This will require the same work from Inland Revenue as currently. (Inland Revenue will not be able to simply make an assessment as otherwise the taxpayer will have discharged the onus of proof through the work they have done.)

It is difficult to see Inland Revenue's complaint as no more than taxpayers disagree/do not accept Inland Revenue's position.

Our submissions take these two perspectives as starting points.

We would be happy to discuss our submissions. Please do not hesitate to contact John (on 04 816 4518) or Kim (on 09 363 3532).

Yours sincerely

John Cantin
Partner

Kim Jarrett
Partner

Permanent establishment avoidance

Proposal

Under the proposed rules (for both DTA and non-DTA countries), a non-resident will be deemed to have a PE in New Zealand (among other conditions) if there is an arrangement under which a related entity carries out an activity in connection with the particular sale made by a non-resident to a person in New Zealand for the purpose of bringing it about.

As an indication of a deemed PE under the definition above, the paper provides an example of a non-resident located in a low-tax jurisdiction selling computer equipment to New Zealand customers, with its subsidiary undertaking certain sales related activities. These activities include locating customers, promoting the non-resident's products to them, discussing their needs and tailoring equipment packages for them, and indicating likely pricing/delivery dates and other key terms subject to the non-resident's approval (which is rarely withheld).

Submission

KPMG considers that the PE avoidance rule should be explicitly limited in legislation to those arrangements which are artificial or contrived.

If Inland Revenue is concerned that tax leakage is occurring in the digital and technology industries (e.g. through their ability to service a New Zealand customer base remotely), we consider that the PE mechanism is not the appropriate way to address this. Rather we suggest Inland Revenue consider refinements to the GST system, or work with the OECD to address taxation of the digital economy.

Comment

KPMG is concerned that Inland Revenue may not take into account modern commercial practice, particularly for technology based businesses. In our experience these companies often operate sales activities in a highly integrated manner across borders, with New Zealand based employees only performing a part of the sales function with New Zealand customers.

Attribution of all sales revenue to a New Zealand PE, in circumstances where the core value-adding sales functions are performed outside of New Zealand, would not reflect the true economic situation of the arrangement and would likely lead to double taxation. A nuanced and fact-specific approach needs to be taken to all such analyses, ensuring that Inland Revenue does not penalise completely commercial (non-tax driven) transactions.

We are concerned that the example provided in the paper may indicate the Commissioner making assumptions based on incomplete industry knowledge. Specifically we comment as follows:

— 'Well paid employees': In the technology sector it is common to have highly paid employees at multiple points in the supply chain, given the qualifications, scarcity of skill set and industry experience needed. This will not be limited to employees that work to build local demand for products in New Zealand, but will generally be a common feature of employees in technology roles across the organisation as a whole. Looking at the salaries of New Zealand employees in isolation provides a false impression of the level of 'value add' provided in New Zealand.

— Use of third party channel providers: In our experience, third party channel providers will almost always be independent agents, and are fully compensated for their role in the sale of products to New Zealand customers under their commercial arrangements with the

supplier. New Zealand income will arise on these transactions, and will be subject to income tax. The use of a third party channel provider, or reseller, should not ordinarily be relevant in considering whether a non-resident has a PE in New Zealand.

- Furthermore, third party channel providers often bundle products from multiple suppliers in order to provide a solution to their New Zealand customer. Again, this is not reflective of an arrangement where a PE could be said to exist for a specific non-resident supplier.
- The term 'specialised services' is not defined or clear.

The labelling of the proposals for DTA countries does not clearly achieve the desired override

Submission

The override of DTAs may not be effective and will at best be uncertain and subject to dispute and cross country disputes. The proposal should be deferred until the effect of the MLI is determined.

Comment

The basis of the DTA anti-PE avoidance proposal is that an anti-avoidance rule is accepted as overriding a DTA. Given that New Zealand and its DTA partners have the opportunity to enter into the MLI and to accept the MLI's proposals to amend the relevant DTAs PE rules:

- It is not clear how the proposed avoidance rule will interact with DTAs which are amended in the same way as the deemed PE rules propose. It would be an odd result if the proposed rule continued to apply despite the DTA allowing New Zealand to tax the profit.
- It is not clear that the substance of the rule is an anti-avoidance rule for those DTAs which are not amended in line with the MLI. Simply, if two countries have not agreed to amend their DTA PE rule, it cannot be contemplated that the structures covered by the deemed PE rule avoid the PE rule in the relevant (un-amended) DTA.
    - We expect this position to be a point of contention between taxpayers, their home jurisdiction and Inland Revenue.
    - This is because the New Zealand proposal is inconsistent with the OECD global proposed approach.
    - The labelling of the proposal as a "deemed PE" rather than a "diverted profits tax" is a mere labelling. It has similar terms to Australia's Multi-National Anti-Avoidance Legislation and parts of the UK diverted profits tax.
    - New Zealand does not follow the OECD authorised approach to attributing profit to a PE.

See our submission on the MLI for further comment and discussion.

The authorised approach to profit attribution

Proposal

New Zealand will continue to apply its position that a PE is not a separate entity.

Submission

The proposals will put pressure on New Zealand's reservation to the OECD's authorised approach to profit attribution to a PE so that the rules will not apply with certainty

The proposals require further clarification of New Zealand's position.

Comment 1

The Issues Paper notes that New Zealand does not accept that a PE should be treated as a separate entity. This means that New Zealand does not accept that a margin can be added to deductible costs of a PE.
This difference is in part the reason why the Issues Paper notes that significant revenue can be expected from the proposals.

A potential outcome of applying the deemed PE proposals to DTAs, which are not amended in accordance with the MLI, is that those countries dispute New Zealand's position on profit attribution. Given the push to have a global consensus, this would put pressure on New Zealand to amend its position.

We acknowledge that this pressure may have been previously successfully resisted by New Zealand in the past. This may have been accepted in part because both parties have the same view of what New Zealand can tax. That constraint would no longer apply under the deemed PE proposal if the DTA is not amended.

Further, if the other party has accepted the MAP, without accepting the PE changes, New Zealand's position will be in the hands of an arbitrator. The status of the reservation in the context of an arbitration is in our view unclear.

Comment 2

We note that in practice Inland Revenue has accepted an implied margin for core functions. For example, in attributing income to New Zealand, a reduced amount may be allocated because an offshore manufacturer is entitled to a profit.

The Issus Paper implies that no margin is allowed at all under the proposed rules. This conflicts with past positions that Inland Revenue has allowed.

Supply chain restructures

Proposal

None

Submission

That the acceptability of supply chain restructures be explicitly confirmed

Comment

The expected reaction to the Australian and UK diverted profits taxes (due to their penal nature) is that taxpayers restructure their agreements and supply chains to create actual PEs or to ensure that their sales are made in either Australia or the UK via buy-sell subsidiaries. This is

likely to be a natural reaction to New Zealand's proposals as well. (Particularly as an abusive tax position penalty is proposed).

Such a restructure is likely to have the effect of eliminating:

- The full profit margin from the sale, that would arise in a deemed PE, reducing this to the appropriate transfer pricing margin under transfer pricing rules for the activities actually carried out in New Zealand; and
- Removing the New Zealand source for expenses incurred offshore (as these will be captured in the price of goods sold to New Zealand).

Alternatively, the restructure may move sales to a higher tax jurisdiction (see further below).

As these would have the effect of "avoiding the deemed PE rule", explicit confirmation that these are contemplated results is required to ensure that the desired and expected restructure is not subject to section BG 1.

Low tax jurisdiction

Proposal

That a deemed PE arises if a low tax jurisdiction is involved.

Submission

Clarity on what is a low tax jurisdiction is required.

Comment

We assume that it is not intended that the statutory tax rate should be used to determine whether a country is a low tax jurisdiction. The BEPS project has shown that the effective tax rate can be lower than the statutory tax rate. We assume that is not the test that will be applied.

Determining the effective tax rate will be a complex matter. As an example we understand that the USA is considering tax reform which, simply, would deny a deduction for expenses paid offshore while exempting foreign sales. Understanding how and whether the particular aspects of such a reformed system applied to New Zealand transactions would not be either simple or clear.

Appropriate and clear rules are required to make this an objective test that can be applied by taxpayers.

Strengthening the transfer pricing rules

Proposal # 1

The Government proposes that New Zealand's transfer pricing legislation should include an explicit reference to the latest OECD Transfer Pricing Guidelines.

Submission

KPMG agrees that New Zealand's transfer pricing legislation should include an explicit reference to the OECD Transfer Pricing guidelines.

Comment

KPMG considers that an explicit reference to OECD Guidelines will provide better certainty to taxpayers, Inland Revenue and the Courts.

We consider this is required because in our view it is Inland Revenue that does not consistently apply the OECD Guidelines in disputed transactions. Legislating the OECD Guidelines will reconfirm to Inland Revenue the tests that it should be applying.

Proposal # 2

It is proposed that New Zealand introduce reconstruction rules based on those in Australia's transfer pricing legislation.

Consistent with Australia's rules, the proposed reconstruction rules would not be explicitly limited to "exceptional circumstances".

Submission

An exceptional circumstances clauses should be explicit and included in legislation.

Comment

In the revised version of Chapter I of the OECD Guidelines, the OIECD strongly cautions against the hasty application of a reconstruction provision noting that,

"*Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult.*"

The OECD Guidelines state further,

"*Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement.*"

The OECD has clearly stated that recharacterisation should be undertaken in exceptional circumstances only. KPMG considers that this should be explicit in the legislation, to avoid any suggestion that these powers may be used arbitrarily or because pricing a transaction is 'difficult'.

An exceptional circumstances clause could ideally include specificity around what would be considered exceptional circumstances similar to what has been outlined in the OECD Guidelines Chapter I. To address one of the concerns raised by Inland Revenue, the clause could specify that even if the arrangement is not unique, the "exceptional circumstances" test may be satisfied.

However, we note that the Government and Inland Revenue should respect and recognise that just because a transaction is not seen between independent parties does not mean it should be subject to reconstruction. This is outlined in the OECD Guidelines,

"Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons."

Proposal #3

It is proposed that the burden of proof should be shifted onto the taxpayer rather than the Commissioner of Inland Revenue. This would align the burden of proof in transfer pricing cases with the standard for other tax matters. As transfer pricing is driven by specific facts and circumstances and involves comparisons with similar arm's length transactions, the taxpayer is far more likely to hold the relevant information to support its pricing than Inland Revenue or any other party.

Submission

KPMG acknowledges that the taxpayer bearing the burden of proof is consistent with other jurisdictions globally. However the burden of proof should be with Inland Revenue when the Commissioner uses information that is available to her and not the taxpayer.

If the proposal proceeds, it should be clear that an Inland Revenue proposed transfer pricing assessment meets a threshold level of reasonableness so that arbitrary and unsupportable positions are not taken by the Commissioner.

Comment

KPMG submits that, should the change in the burden of proof occur, then there should be legislated limits to the ability of the Inland Revenue to leverage what is referred to as "secret comparables" or information pertaining to other companies that are privately held when determining its transfer pricing position.

This is even more important given the depth of information that will soon be at Inland Revenue's disposal with the Business Transformation project, the automatic sharing of information with treaty partners, Country-by-country reporting and other taxpayer information collection mechanisms. In order to ensure a fair and reasonable determination of transfer prices, the comparable information to be used should be limited to what would reasonably be at the company's disposal whether its internal data or data in the public domain. This requirement is of the utmost importance and therefore should be legislated.

We note that currently the burden of proof is only shifted if the taxpayer has applied a transfer pricing method i.e. undertaken the transfer pricing work necessary in relation to their transactions. We consider that this is an appropriate encouragement, in a self-assessment regime, for taxpayers to do the work necessary in order to take a tax position.

A better solution to Inland Revenue's concerns would be to consider either:

- a requirement to disclose the existence of the work at the time of filing the return; or
- filing of the transfer pricing reports and documentation with the returns

to justify the change in the burden of proof. This should assist Inland Revenue with its risk assessment.

In the alternative, if the burden of proof is changed proposed adjustments by Inland Revenue should be capable of being reasonably arguable. This is to prevent Inland Revenue proposing arbitrary or unreasonable adjustments. (We assume that information requested by Inland Revenue, providing that request is itself reasonable, has been provided to allow the Commissioner to propose a reasonable adjustment.)

Proposal #4

There is currently no explicit statutory requirement in New Zealand to prepare and maintain transfer pricing documentation.

Rather than making it mandatory for all arrangements to be documented, the Government proposes shifting the burden of proof onto the taxpayer to encourage higher quality documentation.

Submission

While KPMG does not support legislating that taxpayers prepare mandatory contemporaneous transfer pricing documentation, we submit that a general requirement to prepare transfer pricing documentation, appropriate for demonstrating that a taxpayer has complied with its obligations to undertake related party transactions in accordance with the arm's length standard, should be legislated.

We further note that retaining the current burden of proof in these circumstances would encourage that this be done. This would assist Inland Revenue with its risk assessment and therefore with its efficient deployment of resources.

Comment

Transfer pricing compliance obligations are increasing in nearly every other jurisdiction around the world, and with the introduction of Country-by-country reporting, multinational groups are needing to allocate their resources amongst these compliance requirements. As a result, KPMG is seeing instances of some multinational groups choosing to only prepare formal transfer pricing documentation for countries with an explicit, legislated, transfer pricing documentation requirement.

The need to prepare documentation is implicit in the current transfer pricing legislation. However KPMG considers that this should be an explicit legislated requirement in order to ensure appropriate documentation standards are met by the taxpayer, providing greater assurance of compliance with transfer pricing rules for Inland Revenue, and better certainty for taxpayers.

The preparation of transfer pricing documentation provides an opportunity to reassess whether the pricing of a group's related party transactions are continuing to meet the requirements of the arm's length standard. KPMG is therefore concerned that continuing to operate under an 'implicit' and somewhat looser documentation standard in New Zealand, which is increasingly out-of-step with other jurisdictions, may result in poorer transfer pricing outcomes for New Zealand.

Proposal #5

The Government proposes increasing New Zealand's time bar for transfer pricing matters to seven years.

Submission

Increasing the statutory time bar for transfer pricing matters to 7 years is inconsistent with the need to provide certainty to taxpayers on tax positions taken. It is also unnecessary in light of the increasingly timely information gathering mechanisms at the disposal of Inland Revenue, enabling Inland Revenue to undertake transfer pricing risk assessments promptly once a tax position is taken for any given year.

Comment

— Providing certainty for taxpayers is one of the primary purposes of the time bar. This purpose is as important and relevant for transfer pricing matters as it is for any other provision in the Income Tax Act. Taxpayers require certainty that, after a reasonable period of time has passed to enable Inland Revenue to audit their related party

transactions if considered necessary, no reassessment will be sought by Inland Revenue on transfer pricing matters. We consider the current time bar is fully adequate and sufficient for Inland Revenue to perform any necessary audit procedures and reassessments on transfer pricing matters.

- The rationale provided by Inland Revenue for the extension of the time bar is that it is difficult for tax authorities to adequately identify transfer pricing risk, apply the arm's length principle and amend an assessment within four years, given the need to undertake a detailed analysis of facts and circumstances, comparable data and arm's length arrangements.

- KPMG considers that Inland Revenue now has access to significant amounts of information on the intercompany transactions undertaken by multinationals, and receives this in a very timely manner after the completion of an income tax return for any given income year. Specifically this information includes:
  - Information provided by taxpayers as part of the Basic Compliance Package process
  - Information provided by taxpayers completing the International Tax Questionnaire
  - Information provided by taxpayers who complete transfer pricing questionnaires
    - Information that will begin to be received by Inland Revenue in the short to mid-term through information received from overseas tax jurisdictions through the automatic exchange of Country by Country reporting information and Advance pricing Agreements

  Given this, Inland Revenue is able to perform risk assessment procedures within a very short time of a tax position being taken by a taxpayer.

  Furthermore, given that most, if not all, larger multinationals with a significant level of intercompany transactions, will have already been subject to Inland Revenue risk assessments, reviews and/or audits of their transfer pricing practices, Inland Revenue's focus should be on new or significantly changed transactions. A full reassessment of a taxpayer's transfer prices should not be required every year.

  Given the vast amount of information at Inland Revenue's disposal, and its receipt of that information in short order after a tax position has been taken for a given income year, KPMG considers that it is entirely reasonable for a taxpayer to expect Inland Revenue to have completed any necessary audit procedures and reassessments within 4 years.

- The discussion document references the Australian and Canadian statute bar on transfer pricing matters as support for longer statute bar on transfer pricing matters. Inland Revenue's own data however demonstrates that both the US and UK have 3 or 4 year time bars for both Transfer Pricing and other tax matters. In addition, most of the other jurisdictions listed have the same time bar for both transfer pricing and other income tax matters. This isolated focus on Australia and Canada does not show the broader position.

- The whole focus of Business Transformation is that taxpayers are able to be provided certainty more quickly and more robustly. There is no reason to separate transfer pricing from other matters for which Inland Revenue and taxpayers desire finality.

General comment on transfer pricing and interest limitation rules

A number of references are made in the Discussion Document to the demands that transfer pricing matters place on Inland Revenue resources. KPMG considers that this is an area where

Inland Revenue should be looking to increase the level of specialist staff that it employs, in order to address this complex, and globally significant, area of tax law.

We submit that Inland Revenue should consider this as part of its repositioning its workforce, post Business Transformation, into those skill sets that will be most necessary in addressing increasingly complex tax issues arising from commercial changes in global businesses, and an international tax landscape that increasingly complex and prone to double taxation. This is consistent with changes made in other Revenue Authorities, most notably the Australian Tax Office which has publically announced significant recruitment of international tax and transfer pricing specialists.

Administrative measures

Proposal #1

The Government proposes introducing a new administrative measure to address "non-co-operation" by multinationals.

Submission #1

If such an administrative practice is considered necessary, then KPMG agrees that it should be explicitly legislated for, without reliance on internal administrative practice within Inland Revenue. This should include legislation explicitly stating when a taxpayer will be considered non-cooperative, the threshold at which this will be found and the process that will be used by Inland Revenue before making such a finding (e.g. notice requirements).

Comment #1

The Discussion Draft notes that the non-cooperative administrative measure is not intended to impose unreasonable demands on multinationals. As such, KPMG considers it important that all material aspects of a non-cooperation rule be explicitly legislated for in order to provide certainty, and clear guidance on what is considered by Inland Revenue to be an unacceptable practice or delay, to taxpayers.

Proposal #2

The Government proposes bringing forward the time at which tax in dispute must be paid. There are two potential payment dates being considered for this purpose:

- Within 90 days of Inland Revenue issuing an assessment for the tax (which would only occur at the end of Inland Revenue's current dispute process); or
- Within 12 months of Inland Revenue issuing a NOPA in respect of the tax, if Inland Revenue and the taxpayer have not been able to resolve the dispute.

Submission #1

KPMG considers that there is no reason to have a different rule for the payment of tax in dispute in a transfer pricing matter than for any other tax matter.

Comment #1

The general rules for tax in dispute is that this tax becomes payable on the day of final determination. We see no reason why this should be any different for transfer pricing matters.

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Our ref: BEPS PETPSupplementary

Private and confidential
BEPS - PE and transfer pricing strengthening
C/- Deputy Commissioner, Policy and Strategy
PO Box 2198
Wellington 6140

19 April 2017

Dear Madam

Supplementary submission

We have provided submissions on the deemed PE and transfer pricing strengthening proposals. We have a further submission on the proposals to amend the life insurance rules.

The Document notes that under New Zealand's double taxation agreements ("DTAs") with Russia, Japan, and Canada that New Zealand is unable to tax the life insurance business if a resident of those countries does not have a permanent establishment in New Zealand.

Briefly, New Zealand's framework for taxing insurance business of a non-resident is:

- For life insurance, to tax all business offered or entered into in New Zealand;
- For non-life insurance to tax 10% of the premium income if there is no fixed establishment in New Zealand.

New Zealand's DTAs typically preserve New Zealand's entitlement to tax insurance business in this way whether or not a permanent establishment exists.

The document does not say why these DTAs have not followed this approach.

We have only been able to determine two possibilities:

- New Zealand accepted a proposal by those countries to change its standard approach to taxing insurance business;
- The change in these DTAs was inadvertent, mostly likely due to a change in drafting go the relevant provision.

Neither of these reasons support the proposals. In fact, they indicate that the proposal is unprincipled. The proposals unilaterally alter the basis of taxation. The correct approach would be to renegotiate the relevant provision with the other country.

We do not accept a technical response that the proposals do not tax the non-resident insurer. The denial of the deduction for a premium (albeit offset by not taxing claims received), makes the policyholder a proxy taxpayer for the non-resident insurer. This change is likely to lead the policyholder to try to alter the terms of the agreement so the non-resident insurer is effectively bearing the tax. The substance of the proposal is the non-resident's profit is taxed.

Further, the proposal to amend the FIF rules potentially creates double taxation.

For completeness, we note our objection to the proposals is one of principle. We are not aware of insurers using the relevant DTAs. However, we consider the proposals unprincipled in their unilateral change. As we note in our submissions on Interest Rate Limitations, it is also a worrying trend that the substance of a proposal is not made transparent. In this case, the proposal seems to be directed to correcting an error rather than addressing a matter of principle.

Further information

Please do not hesitate to contact us – John Cantin, on 04 816 4518, and Nick Hope, on 09 363 3210 – if you would like to discuss our comments in more detail.

Yours sincerely

John Cantin
Partner

Nick Hope
Director

OXFAM
New Zealand

Deputy Commissioner Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

Taxation of Multinationals - Discussion Documents

Dear Madam,

Oxfam welcomes positive steps by this Government to address the unfair situation where the world's richest and most powerful companies and people are avoiding paying their fair share of tax. Tax is key to making sure everyone has vital public services. It is an essential tool to ending extreme inequality, and could help lift millions of people out of poverty. It is estimated that poor countries are losing at least $170 billion every year because of tax avoidance - this is more than the total amount that these same countries are receiving in aid. When taxation works fairly, the majority benefit.

New Zealand could be missing out on up to $500 million a year in tax from multinational companies - money that could be spent on health, education and housing. On a broad level we support the proposals in the documents however we are concerned that **they do not go far enough;**

- in ensuring that New Zealand receives its fair share of tax from multinationals operating in New Zealand
- in committing New Zealand to collaborate on issues of greater transparency around tax practices globally.

Our comments on proposed rules and recommendations are below.

BEPS - Transfer Pricing and Permanent Establishment Avoidance

Oxfam has long been concerned about multinationals not paying tax in the countries they operate in and trade with as it deprives the host countries of tax revenues to spend on desperately needed social services for the local populations.

Diverted profits tax

To that end Oxfam has been supportive of and has called for a Diverted Profits Tax to counter such behaviour. We are supportive of the government's moves to bring in an equivalent measure. We note however that the tests suggested include a consideration of whether the structure is contrary to the purpose of the respective double tax agreement.

Recommendation: Oxfam recommends that the proposed diverted profits tax equivalent does not reference any double tax agreement but focus simply on the other objective tests.

- a non-resident supplies goods or services to a person in New Zealand;
- a related entity (either associated or commercially dependant) carries out an activity in New Zealand in connection with that particular sale for the purpose of bringing it about;
- some or all of the sales income is not attributed to a New Zealand permanent establishment of the non-resident;

Recommendation: Oxfam recommends that New Zealand's double tax agreements are reviewed to ensure New Zealand can receive its fair share of tax revenue from multinationals and if favourable renegotiation is not possible then the double tax agreements should be rescinded.

BEPS - Interest Limitation Rules

Interest deductions

Oxfam notes that the government has chosen not to implement the earnings stripping rules recommended by the OECD. We are comfortable with this only if the government can assure the people of New Zealand that what it is proposing is equally effective.

On that basis we support the proposals in this document as interest deductions are a very straightforward way of reducing profit by multinationals. For this reason we particularly support:

- The removal of non-debt liabilities from the assets component of the debt to assets test. Such a move will level the playing field between multinationals that would commercially use debt to fund fixed assets and those that wouldn't. For this reason Oxfam strongly supports this move.

- The other proposal we particularly support is the removal of the 10% related party debt allowance for conglomerates including Public Private Partnerships (PPP). Currently PPPs are allowed to deduct all unrelated party debt plus 10% of their related party debt. As related party debt is a "profit stripping" device Oxfam does not see the logic of this and we are pleased to see the proposal to remove it.

Excessive interest rates

Oxfam is aware of the current loophole where high levels of debt can feed into a high interest rate for transfer pricing purposes. We therefore support the intent of the proposals to eliminate this. We note that the proposals are to:

- apply the credit rating of senior unsecured debt for multinationals with an identifiable parent;

- assess the level of arms-length debt and then the applicable interest rate when there is not an identifiable parent.

It is the second option that causes us concern. Multinationals without an identifiable parent include Private Equity (who are known to take a tax aggressive approach to investment). To find a comparable level of arms-length debt our understanding is that you need to find the debt level of a comparable New Zealand owned firm. Given the high levels of foreign ownership in all our major industries, Oxfam would question whether identifying such a comparable firm was possible. We note that even iconic New Zealand firms such as Spark and Fletcher Building have significant levels of foreign ownership. Even in industries that still have some level of New Zealand ownership such a move will incentivise full foreign ownership so that high levels of interest deduction can become the norm.

Recommendation: It is not our first preference to require all related party interest to be disallowed but if these are the only options available, they have to be taken to ensure entities such as Private Equity pay their fair share of tax. We suggest that if related party interest disallowance is considered excessive; earning stripping rules must be reconsidered for this group.

Omissions on current proposed rules

Global collaboration on tax

Oxfam is an international development agency and our mission is to eliminate poverty globally. We see progressive tax systems (spent progressively) as one of the levers to be able to achieve this goal. While there is a lot that governments can and are doing on their own to improve the progressiveness of their tax systems, such as this consultation on tax policy in New Zealand, there is a limit to what countries can do unilaterally.

Earlier this year, Oxfam released a report that revealed that 8 men own the same wealth as 3.6 billion people who make up the poorest half of humanity. Tax havens are part of this problem. In order to end poverty and inequality; we have to end tax avoidance globally.

Recommendation: Oxfam is calling on all countries to allow for greater collaboration on taxation. A fair and level playing field on corporate tax requires transparency measures, including full public country by country reporting, transparency on beneficial owners and transparency by governments on the tax incentives they grant and in particular on tax rulings.

Non-resident finance companies

Another omission is any move to apply specific interest limitation rules to non-resident finance companies. The issue is they currently only have the on-lending concession apply to them meaning they can have unlimited and unconstrained interest deductions (as was the case with the Australian banks before the specific bank rules were implemented).

We understand that there is currently not a high level of non-resident finance companies operating in New Zealand. Oxfam accepts that this may be currently the case but this can change very quickly (as was the situation with the banks).

Recommendation: While all the other measures are correcting issues that have been in place for some time, we suggest that it would be preferable to fix identified issues before they become a ‘significant drag’ on the tax base thereby affecting the government's ability to provide social services.

Oxfam welcomes these consultation documents and we recognise that this a positive first step to ensure multinational companies pay their fair share of tax from profits earned in New Zealand. As stated above we do strongly recommend the inclusion of policies that promote greater collaboration on tax globally to tackle the growing issue of inequality.

Oxfam wishes to acknowledge the significant assistance provided by Andrea Black, adviser to Oxfam, in the research and analysis of the Tax Consultation Documents. Oxfam also greatly appreciates the access to your officials and the open and insightful discussions they had with Andrea Black.

We would be happy to discuss any of these points in more detail. Please contact Paula Feehan- Advocacy and Campaigns Director at paula.feehan@oxfam.org.nz.

Yours sincerely,

Rachael Le Mesurier
Executive Director
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NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

Submission of the New Zealand Council of Trade Unions Te Kauae Kaimahi

to the

Inland Revenue Department

on the

Proposals to strengthen New Zealand's rules for taxing large multinationals (BEPS)

P O Box 6645
Wellington
18 April 2017

1.1. This submission is made on behalf of the 30 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With 320,000 members, the CTU is one of the largest democratic organisations in New Zealand.

1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.

1.3. Thank you for the opportunity to comment on the three discussion papers on “Base erosion and profit shifting” (BEPS):[1]

- BEPS – Transfer pricing and permanent establishment avoidance
- BEPS – Strengthening our interest limitation rules
- New Zealand’s implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.

1.4. We have read these and support their general directions. We make this brief submission in order to indicate our ongoing interest in these matters and our wish to be consulted as this area of policy progresses.

1.5. The loss of revenue from tax avoidance and evasion has a direct impact on our members in loss of revenue for public services which we value, and in higher taxes than otherwise necessary on working people.

1.6. One area is of special concern: the avoidance of tax by multinational internet-based corporations such as Google and Facebook puts local carriers of advertising such as newspapers and broadcast television and radio at a competitive disadvantage. The business model of conventional news media is already severely weakened by changes in technology brought largely through the internet and other forms of digital media and communications. The advertising revenue on which the conventional media depend is undermined by these new technologies, which they are struggling to respond to. It makes it even more difficult if their competition can lower their costs by avoiding paying tax on their activities.

[1] http://taxpolicy.ird.govt.nz/consultation

1.7. This is a matter of public interest: the conventional media are still the principal originators of the content on which we largely depend for reliable news, and particularly for news about New Zealand. The steady loss of capacity through lay-offs of journalists and other media staff is creating a major failure in the news media market.

1.8. There is therefore a strong public interest case to ensure that provision of advertising services and platforms is tax neutral. We are gravely disappointed that the proposals do not address the tax avoidance of Google, Facebook and others. We urge IRD to address this.

1.9. The only other matter we would like to comment on is that it would be very valuable for IRD to regularly publish summary information on the taxation of multinationals in the New Zealand. This would give the public the information that is necessary and sufficient for informed discussion of such matters and to judge whether measures such as those discussed in the present documents are effective. We urge IRD to do so.

TP EQuilibrium | AustralAsia LP

A Duff & Phelps Transfer Pricing Alliance Partner

To: Deputy Commissioner of Taxation, Policy and Strategy, New Zealand Inland Revenue

From: Leslie Prescott-Haar, Stefan Sunde / TP EQuilibrium | AustralAsia LP

Subject: BEPS – Transfer Pricing and PE Avoidance

Date: 18 April 2017

TP EQuilibrium | AustralAsia ("TPEQ") has prepared this submission in respect of the New Zealand Government's discussion document, *BEPS – Transfer Pricing and PE Avoidance*, published in March 2017.

TPEQ has prepared these comments on the discussion document specifically, and selectively, from a transfer pricing perspective. Our comments are based on our transfer pricing experience with Australian and New Zealand transfer pricing matters. In this regard, we have limited our comments to certain proposals contained in Chapters 5 and 6 of the discussion document. As such, TPEQ has not commented on all aspects of the various proposals. Our comments with respect to Chapter 5 are substantive, whereas our comments with respect to Chapter 6 are practical.

We are comfortable discussing these points raised further with the Inland Revenue or Treasury officials, as may be requested.

The submission is generally structured in alignment with the structure of the discussion document, unless otherwise indicated.

Overall 'General' Comments

Whilst we welcome alignment with the most current OECD guidance, and we recognise the importance of trans-Tasman trade flows, we caution against a desire for alignment with Australia's transfer pricing rules, simply for the sake of alignment.

Australia's revised transfer pricing regime is exceptionally burdensome, excessive in terms of compliance costs, over-steps the OECD Guidelines in various respects, will likely result in a materially increased number of disputes, and remains unchallenged in the Australian courts. Therefore, we urge caution against interpreting that legislation as "a good way" to challenge situations where legal form does not match economic substance.

Moreover, the discussion document appears to misinterpret Section 815-130 of Australia's revised transfer pricing regime as a reconstruction provision, rather than a provision to identify the arm's length conditions of a transaction.

Proposals to consider reconstruction of transactions are unduly aggressive, and such should be avoided unless in exceptional circumstances

The proposals contained in the discussion document relating to the reconstruction of a transaction where its form does not align with the economic substance must be considered carefully. In particular, Para. 5.39 notes that, under the proposals, New Zealand's rules would not restrict reconstruction to only "exceptional circumstances". We also note that, contrary to the OECD Guidelines, there appears to be an intent (para. 5.29) to target transactions only rarely occurring between third parties. Per the revised OECD Guidelines[1]:

> *The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The* ***non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle****. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement.*
>
> *The structure that for transfer pricing purposes, replaces that actually adopted by the taxpayers should comport as closely as possible with the facts of the actual transaction undertaken whilst achieving a commercially rational expected result that would have enabled the parties to come to a price acceptable to both of them at the time the arrangement was entered into.*

Any New Zealand legislative and/or IRD approach which is inconsistent with the OECD guidance would be unsatisfactory in New Zealand's transfer pricing framework, having regard to the evidential burden placed upon multinationals to disprove hypothetical reconstructions; this would result in excessive compliance costs for operations that are insignificant (for most multinationals); and would likely materially increase in the number of disputes, Competent

[1] Final OECD BEPS Reports – Actions 8-10, paras. 1.123 – 1.124.

Authority cases, and instances of economic double taxation. In this regard, the New Zealand avoidance regime and case law are already highly effective deterrents against aggressive taxation arrangements, as the Commissioner already has broad discretion to reconstruct tax avoidance arrangements appropriately, and adequately address such ‘problematic’ structures. Given the effective workings of New Zealand’s anti-avoidance regime, it is not necessary for New Zealand to introduce separate reconstruction provisions within the transfer pricing rules. As such, it is inappropriate for the Inland Revenue to “re-write” the terms and conditions of multinational transactions for a variety of reasons, except in exceptional avoidance circumstances. Instead, a provision making reference to the OECD Guidelines, as the most current internationally accepted guidance, would appear to suffice with regards to alignment of substance with legal form.

Per Para. 5.29, we caution against ‘risk shifting’ as an indicator for any recharacterisation. We note that, for example, there is limited rationale to establish a low-risk distributor, other than to create a stable, low-risk entity, which for a multinational reflects a commercial arrangement that may simply not be available to independent parties. The limited risk distributor approach is a common and well accepted inbound and outbound structure which minimises transfer pricing risk for the distributor and its group, including by the Inland Revenue in APAs. Conversely, the financial results of full risk marketer-distributors are often highly variable (as a result of market/economic conditions, currency exchange rates, etc.) and such variability of distribution profitability inevitably attracts the scrutiny of revenue authorities around the world. This is only one example of various possible structures that apportion risk in a particular way, with sound commercial basis, but do not indicate aggressive profit shifting.

Further, risks are contractually transferred globally every day in uncontrolled transactions. Hence, risk shifting should not be a primary factor considered as part of a potential recharacterisation. We note that section 815-130 of Australia’s Income Tax Assessment Act 1997 does not address risk in such a granular fashion.

Further to the above, the nature of the New Zealand dollar as a ‘commodity’ currency, making NZS exchange rates typically more volatile, provides further justification for limited risk approaches in respect of controlled transactions with New Zealand, to improve stability, certainty and long term profitability of New Zealand businesses.

Administrative Measures

The comments below are based on TPEQ’s practical audit experience.

In our experience, audit delays are typically not attributable to taxpayer non-cooperation. In this regard, multinationals would [almost always] prefer to respond to audit queries and resolve audits as quickly as reasonably possible, with a view to progressing the matter to its final conclusion, achieving certainty over the outcome at the earliest opportunity. Audit issues experienced by the Inland Revenue may, to a large extent, reflect requests for information that simply does not exist within multinationals, or is not prepared in the normal course of business management and / or decision-making. It is inevitable that there would be some delay in providing such information, as it may take considerable time to collate or prepare, this having to be balanced with other commercial imperatives. The necessity for broad administrative legislative changes is therefore lacking.

Instead, we believe a flexible process facilitating ‘open discussions’ with the Inland Revenue relating to their audit information requests would be more effective and should be implemented, to balance the Inland Revenue’s information needs with multinationals’ compliance costs. Per the general USA IRS procedures, information requests are initially

provided to taxpayers in draft form, providing an opportunity to discuss the nature and extent of the information requested as compared to what is available, and tailor the request to the specific circumstances and risk profile of the taxpayer.

On Para. 5.71, should the 7-year statute bar for transfer pricing assessments become law, then the Inland Revenue should, as a practical matter, become more open to longer term APAs.

We note the intent that the proposed measures would leave co-operative multinationals largely unaffected (para 6.13), but we have concerns in practice that this would not be the case. We also note the intention to implement internal review processes to ensure such measures could not be applied lightly (para. 6.18), but the discussion paper remains vague on what would be considered "reasonable in the circumstances" (para. 6.17).

On Para 6.19, for non-cooperative major multinationals, it could presumably be evidentially unfavourable for the Inland Revenue to issue NOPAs that are based on incomplete evidence and / or insufficient analysis, as well as being procedurally inefficient for both the Inland Revenue and multinationals. Whilst we understand the Inland Revenue's need to address the minority of taxpayers that are non-compliant, we believe that the existing provisions represent an adequate and effective arsenal available to the Commissioner.

On Para 6.26, it is unfair to penalise all multinationals for the sins of a few, by requiring all taxpayers to make upfront 'pay to play' tax payments based on insufficiently evidenced NOPAs. Also, limiting repayment of disputed tax only in the event of a successful court challenge (para. 6.25) excludes the possibility of other dispute resolution mechanisms. Payment of disputed tax should be made upon resolution of the matter by any means.

Para 6.35 appears quite draconian and punitive, as a New Zealand person could potentially be convicted for the directions and/or actions of others, or alternatively, in connection with an information request covering information that does not actually exist. In relation to the latter point, the proposed approach does not recognise that, even where the relevant person is willing to co-operate, it may be difficult for them to prove that the requested information simply does not exist.

#005

BEPS – Transfer pricing and permanent establishment avoidance

Submission, 18 April 2017

Chartered Accountants Australia and New Zealand

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18 April 2017

BEPS – Transfer pricing and PE avoidance
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Dear Cath

BEPS – Transfer pricing and permanent establishment avoidance

Thank you for the opportunity to comment on the Government Discussion Document on transfer pricing (TP) and the permanent establishment (PE) rules.

In summary our submissions are as follows:

General comments

- We accept that the Government is concerned about BEPS and committed to introducing appropriate measures to combat BEPS.
- We agree that BEPS is detrimental to the public perception of our tax system; and may also be detrimental to New Zealand's economy.
- We are concerned that by implementing unilateral measures outside the OECD BEPS Action Plan the Government could harm our relationships with treaty partners.
- We are not convinced that the PE model will always be appropriate for digital business models and suggest another model is needed.
- We believe any new rules must be clear and specific to give certainty to taxpayers, particularly foreign investors.
- We believe any recommendations adopted as a result of this Discussion Document should be factored in to Inland Revenue's Business Transformation project so that the Commissioner can develop specialist teams to meet changing customer demands.

Permanent establishment avoidance

- It is unclear why, if the proposed rule is to counteract an entity avoiding the application of a relevant treaty, that the Commissioner cannot apply section BG 1 currently.
- It is unclear how the proposed avoidance rule will fit into our existing treaty framework.
- An uncertain rule will discourage foreign investment so it is critical that, if a rule is required, the rule is targeted and clear.

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- The Commissioner should specify all of the relevant factors she considers indicate the presence of avoidance. For example she should be specific about which countries the Government considers to be “low tax jurisdictions”, and how other indicia will be considered, including what is meant by a “well paid employee”.
- Guidance should be given as to how the Commissioner will attribute any resulting profit.

Amendments to the source rules

- The Government should provide examples to explain how the proposed PE source rule would apply and to which foreign income.
- The anti-avoidance source rule goes further than the BEPS measures proposed by the OECD and we do not believe this is appropriate.
- We agree that there is a discrepancy in tax treatment for life insurance businesses depending on the particular DTA but believe this discrepancy should be resolved by amending the particular DTAs.
- We agree that it is not necessary to have a royalty substitution rule.

Transfer pricing

- A legislative reference to the OECD transfer pricing guidelines should state that the guidelines apply only to the extent they have been adopted by New Zealand – or the guidelines should be put into regulation with reservations specified in a separate schedule or appendix.
- We are concerned that an “economic substance” test would be uncertain and difficult to administer and believe the test needs to be clearer and more tightly defined.
- If a reconstruction provision is introduced, the standard should be whether a taxpayer would be “more likely than not” to have agreed such an arrangement with a third party and an “exceptional circumstances” type test should be explicit. The same test should be adopted if a criterion of arm’s length “conditions” is introduced into legislation.
- We do not believe the burden of proof should simply be reversed. If the burden is to be shifted to the taxpayer then, at the least, the burden should be on the Commissioner in situations where she is using data that is not available to the taxpayer.
- We understand most multinational enterprises of this size provide the proposed documentation already and we do not have a problem with the requirements being formalised in legislation.
- Moving the time bar to seven years for transfer pricing issues is inconsistent with Inland Revenue’s move to customer centric, real time service and should not proceed. If resourcing is an issue, more resource should be allocated.
- As a practical matter, many investors with minor interests will not be involved in transfer pricing decisions and will not have access to transfer pricing documentation so the rule needs to have some flexibility to allow for this.

Administrative measures

- We question whether the new administrative measures are needed when most multinational enterprises cooperate with Inland Revenue.
- Any increase in administrative sanctions should be accompanied by corresponding measures to encourage and assist taxpayers to comply.
- We do not believe the Commissioner should have the power to impose fines. If this proposal

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were to proceed, we believe any imposition of a fine should need the signoff of an independent third party such as a TRA judge or the Attorney-General.

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CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

General comments

The OECD has issued the BEPS Action Plan in order to reset the global consensus on how to tax cross-border commercial activities.

We believe the New Zealand Government must first be clear on its desired international tax policy settings and then the extent to which these are already achieved through current legislation, including an anti-avoidance rule, and adoption of the Multi-lateral Convention (MLC). If not, the Government must then determine the extent to which any further legislative reform might be needed.

We understand the Government is concerned about BEPS activities in New Zealand and we agree that BEPS is undesirable, in particular, because it affects the public perception, and thus the integrity, of our tax system. It may also be detrimental to New Zealand's tax take.

It is not clear whether the Government has developed the current proposals because it has decided to unilaterally act, outside of the MLC, to achieve its international policy settings; or whether it has developed them to deal with perceived issues with the public perception of the tax system.

Existing treaty framework

It is unclear how the proposed rules will fit into our existing treaty framework.

The proposal is stated to be a new avoidance rule. However it is not clear in the discussion document as to what the Government asserts is the test that, if avoided, will cause the proposal to be applied.

We presume that if a foreign jurisdiction implements the MLC then the proposed avoidance rule would not apply as the treaty should apply to any suggested avoidance. However it seems unclear what could occur if the relevant treaty partner does not implement the MLC in full. Is it proposed that New Zealand will apply the avoidance rule notwithstanding the negotiation with the treaty partner concluded on a different basis?

If another country does not accept the relevant MLC it is more difficult to make the argument that the proposal is an anti-avoidance rule. The parties will contemplate that a PE (and, therefore, a taxing right) would not arise.

A unilateral action also creates a risk that our other treaty partners may respond in a similar way. A similar response from other countries could limit New Zealand's tax take, rather than increase it, by having the reverse impact for New Zealand businesses trading overseas.

We suggest Officials consider delaying the application of the deemed PE rule for DTA countries until after the implementation of the MLC.

Effect on foreign investment

In our view, many of the proposed rules seem to be directed towards perceived problems. The proposed rules are framed widely and in many cases the boundaries are unclear. We are pleased that Officials first developed an overarching inbound investment framework and believe that has been a

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useful reference for New Zealand's policy settings. We believe Officials must now develop a coherent and cohesive set of rules within this framework that target only those arrangements that are of real concern.

If the rules are not sufficiently clear, they will have a significant effect on taxpayer certainty, particularly for overseas companies looking to conduct business here. In our specific submissions, we have made suggestions for areas where we believe explicit criteria are needed.

Relevance of the PE model

In our view, the proposals in chapters three and four attempt to force the PE model on to a type of business that does not fit into this model. It is a natural consequence of the information age and the sharing economy that, for many businesses, the value will be in its operational model, network and/or customer list. Its business may be conducted from a website rather than from bricks and mortar premises. We do not believe that the traditional concept of a PE is useful for taxing digital age businesses in all cases.

It is not the subject of the discussion document, however we consider that the OECD needs to develop a new model that will be more appropriate for taxing new economy businesses.

In the absence of a new model, the Government runs the risk that anti-BEPS measures will disadvantage taxpayers with new or innovative business models in the future. Encouraging growth and innovation is firmly on the Government's agenda. New and innovative businesses, including those from overseas, will be critical in growing the economy. In order to encourage foreign investment it is critical that we have clear and workable tax rules that are fit for purpose

Implementation

Inland Revenue has embarked on a Business Transformation programme which, we understand, will include a significant re-allocation of resources and restructure of many roles.

This presents an opportunity to develop specialist teams to resource the initiatives outlined in this Discussion Document.

For example, the Discussion Document assumes that Inland Revenue will need to audit to discover the relevant transactions and corresponding transfer pricing documentation. The transformation project provides an opportunity for Inland Revenue to establish customer service teams to assist taxpayers at the time the transactions occur and provide real time signoff on compliance.

Such an approach would give greater certainty to taxpayers and as a consequence would not require the Government to change the statute bar or the burden of proof as currently proposed.

Chapter 3: Permanent establishment avoidance

The Government proposes to deem a PE to exist where a non-resident makes sales into New Zealand, a related entity carries out activities in relation to the sale and the sales income is not all attributed to a New Zealand PE of the non-resident.

Application of the rule

The proposed rule is outlined at paragraph 3.21 of the Discussion Document. Paragraph 3.24 outlines the factors that will be relevant in determining whether the test is met.

We do not believe it will always be clear when an arrangement "ought to" result in a PE. Therefore it is imperative that the rule is clearly articulated with particular attributes clearly specified. It is important that the rule is crafted using language using specific criteria and is neither vague nor emotive in terminology.

While the proposed rule is touted as an avoidance rule it is not clear that in fact the typical indicia of avoidance are in fact required before the rule is implemented. Further it is not clear what PE test the Government is concerned with.

Any application of avoidance in New Zealand would typically include the consideration of the economic reality of the arrangement and whether there are the relevant indicia, such as artificiality, circularity, or non-commercial features that lead to the conclusion that the arrangement was an avoidance arrangement. It appears that in this instance the Government is suggesting that the existence of certain factors could trigger the rule notwithstanding these could be commercial activities.

Paragraph 3.25 states that the legislation may specify some of the factors. We agree and believe that, if possible, it should specify all of the factors. But more so the Commissioner should be required to show that the non-resident had in fact entered into a tax avoidance arrangement.

At para 3.2 the Government suggests that "The proposed rule is an anti-avoidance measure. It is intended to apply where the non-resident's economic activities in New Zealand should result in a PE here, but the non-resident has been able to restructure its legal arrangements to avoid one arising".

However what test of a PE is to be applied in this instance? What PE test is to be considered to have been avoided? In para 3.45 it is proposed that no reference will be had with the particular PE test in the relevant DTA. It is perhaps implied in paras 3.40 and 3.41 that reference is to be had to the PE test that is in the Model Convention, which will presumably mirror the MLC. If this is to be the case is the Government suggesting that it would seek to apply the proposed test to a taxpayer of a foreign jurisdiction that has not accepted the MLC PE test?

This has the potential to result in large and time consuming MAP disputes.

"Low tax jurisdiction"

Of the factors listed, the most significant is the last bullet point and, in particular, the "involvement of a low tax jurisdiction". We believe the Government must give concrete guidance on the meaning of "low

tax jurisdiction".

One of the issues for all involved is whether "low tax" criterion refers solely to the corporate tax rate, or to preferences in the tax system more broadly. For example, we understand the US proposes to allow income from sales to non-residents to remain untaxed. Would this qualify it as a "low tax jurisdiction"? If not, what more would be needed?

We believe the Government should publish lists of countries whose tax systems it considers to have the features of a "low tax jurisdiction" and a list of those whose it does not. This was an approach used successfully for many years under New Zealand's former Foreign Investment Fund (FIF) rules. Specific lists would provide certainty for taxpayers as to the Government's concerns.

"Well paid employee"

The Discussion Document also states one of the factors to consider would be an entity that is allocated a low amount of profit, on the basis that it is carrying our low value services, while having a number of "well paid employees".

In our view any legislation must be specific about what is meant by "well paid employee". This is an example of vague and emotive terminology and should be replaced by or elaborated by reference to specific criteria.

Abusive tax position penalty

The Discussion Document states (paragraph 3.38) that, if the proposed rule is applied, an abusive tax position penalty would also apply. We are not convinced that this is appropriate, as the proposals seem intended to target arrangements that would not meet the criteria of "tax avoidance".

In addition, if a taxpayer may be subject to an ATP penalty (and thus double their tax bill), there is an onus on Inland Revenue to clearly articulate the rule. In addition, we believe IR must give greater access to binding rulings, within commercial time frames, to allow taxpayers certainty for their transactions.

"But for" test

The Discussion Document also proposes a "but for" test (paragraph 3.26). The rule will deem a PE to exist only if the non-resident would have had a PE but for the arrangement with the related party. The "but for" test is intended to prevent a PE being created where one does not exist in substance – consistent with paragraph 3.22, which states that preparatory or auxiliary activities would not be sufficient. We believe this test will be useful and should be specifically included in the legislation.

We note that the definition of "preparatory or auxiliary" activities will change once the MLC is implemented but assume the reference is to the current definition.

Consequences of application

The Discussion Document states (at paragraph 3.36) that Officials expect that the application of the principles will result in a "fairly significant" amount of the sales income being attributable to the deemed

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PE and a “material amount” of net profit to remain.

It is important to clarify what is meant by “fairly significant” and “material amount”. We would like to discuss this further with you and work through some examples to clarify. We believe any legislation should also be accompanied by specific guidance as to how profit is to be attributed.

In the absence of a clear statement, taxpayers are more likely to err on the side of caution and decide not to place any personnel in New Zealand. Such a decision to exit employees from New Zealand would be motivated not by a desire to pay no tax in New Zealand, but by the uncertainty inherent in a profit attribution.

Moreover, future inbound investment into New Zealand depends on foreign investors being able to cost future commercial arrangements accurately. Foreign investors are generally willing to budget for a New Zealand tax liability but the calculation method must be clear.

Interaction with New Zealand’s double tax agreements

It is not clear how these proposed rules will fit into our existing treaty framework.

The Discussion Document states (paragraph 3.42) that the proposed rule is an anti-avoidance rule that will apply only to an arrangement which defeats the purpose of the DTA’s PE provisions.

However, as the Discussion Document acknowledges at paragraph 5.45, there is an increasing variety of commercial arrangements in multinational enterprises. We believe it will not always be obvious when a Government may consider an arrangement is intended to defeat the purpose of the DTA’s PE provisions. The concept of “commercial and economic reality” is not defined and is often problematic in practice. An unusual arrangement may be undertaken for genuine commercial reasons. It is critical that the proposed rule allows for a distinction between “novelty” and “avoidance”. The focus should be on artificial arrangements.

If the proposals are implemented in the form proposed, they will leave taxpayers and advisors with a lack of clarity as to when an employee of an overseas company located in New Zealand would have function and responsibility sufficient to give rise to a PE. For example, would a person located in New Zealand who plays a principal role but does not conclude contracts constitute a PE here?

The Discussion Document states (paragraph 3.39) that the ultimate aim of the proposed rule is to “discourage non-residents from entering into PE avoidance structures in the first place”. We understand this objective but believe there needs to be a balance between discouraging investors who would engage in avoidance behaviour and encouraging genuine foreign investment.

The resulting lack of certainty may result in taxpayers and advisors taking a conservative approach and not basing employees in New Zealand, so that there is no risk of inadvertently creating a PE. This outcome does not seem sensible and would stifle growth and investment.

We agree with the statement (paragraph 3.45) that taxpayers should not be able to rely on DTAs to protect tax avoidance arrangements. However, we believe that taxpayers should otherwise be entitled to rely on DTAs.

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Chapter 4: Amendments to the source rules

Permanent establishment source rule

The permanent establishment source rule would give income a New Zealand source where the income is attributable to a PE in New Zealand, whether or not the income has a New Zealand source under any other source rule.

We assume this rule is intended to refer to foreign income created by activities of the New Zealand PE that was hitherto not taxable here. We would appreciate some examples to illustrate how the rule would work in practice.

Anti-avoidance source rule

The Government proposes that a non-resident's income would have a source in New Zealand if it would have a source, treating the non-resident's wholly owned group as a single entity.

This would effectively introduce a "force of attraction" type of rule into New Zealand legislation. Such a rule – where a country can impose tax on the total income of a business with a PE there, even if the income is not earned by that PE – would be out of step with New Zealand's international tax framework, which taxes on PE and source, and goes further than the rules to be adopted via the MLC. We do not agree with this.

The Discussion Document refers to section CV 1 in support of the proposal.

It is our understanding that section CV 1 is a recharacterisation rule intended to prevent income splitting. For example, if a share dealer were to establish fifty different companies, each owning shares in a different company, in order to suggest that none of the companies are dealers. Section CV 1 would apply and consider the position of the group as a whole.

We believe a recharacterisation rule to target fragmentation and contract splitting could be appropriate, however, this would be a significant extension of our current PE rules.

Life insurance source rule

We agree that the combination of section DR 3 and the wording of Article 7 in the DTAs with Canada, Russia and Singapore results in a more favourable tax treatment for life insurance businesses operating out of those countries.

In our view, this would best be rectified by agreeing a protocol as part of the DTAs involved, rather than imposing a domestic law override. We also wonder whether there could be wider foreign policy implications of creating a domestic law override to a negotiated agreement.

Royalty substitution rule

We agree that a royalty substitution rule is not necessary in New Zealand. We already have an "in substance" royalty definition.

Chapter 5: Strengthening the transfer pricing rules

Including an explicit reference to the OECD transfer pricing guidelines

In our view, most businesses and advisors, as well as Inland Revenue investigators, generally apply the latest OECD transfer pricing guidelines. We do not believe the proposals will result in a significant change in practice.

However, the amendment will make any New Zealand reservations more important (for example, we do not view a branch as a separate entity). The legislative provision should specifically state that the guidelines apply domestically only to the extent that New Zealand has adopted those guidelines and do not apply to the extent of any reservations we have made.

We suggest the guidelines we have adopted are put into regulations, with a separate schedule detailing the areas where New Zealand has entered reservations.

It will be more imperative than ever that the Government remain engaged in the negotiations to ensure that the guidelines are adopted only to the extent that they are consistent with our domestic law and that the Government is able to enter reservations if that is not the case.

Aligning the transfer pricing rules with economic substance

We understand the rationale behind the proposal to introduce an “economic substance” test.

However, we have concerns about how the test will be implemented in practice. The concept is a matter of judgement and, inevitably, there will be grey areas.

By its nature transfer pricing documentation reflects an agreement between related parties. It is possible that a taxpayer would request a different arrangement, or different terms, if they were negotiating with a third party.

We were recently given an example of a multinational entity with related entities in many countries. The MNE decided to enter into a new country and to license a third party in the new country to perform the services there. The same services were undertaken by related parties in all other countries. The presence of the new third party agreement immediately raises the issue of whether all related party agreements must now have the same terms as the third party agreement.

We believe Inland Revenue should explain to interested parties how it intends to administer the concepts in practice (and how this administration will be resourced). For example, in the above situation, would all related party agreements need to have the same terms and conditions as the new third party agreement? What factors would the Commissioner take into account in making her decision?

The Discussion Document states (paragraph 5.30) that the OECD guidelines focus on funding, intangible assets and legal risk. If the New Zealand Government also intends to focus on these three areas they should also be included in the legislation or, at the least, referred to in guidelines or a policy special report.

Reconstruction

The document states at paragraph 5.35 that the reconstruction should "make the related party dealing align with a commercially rational arrangement that would be agreed by independent businesses operating at arm's length". It goes on to say that "if the commercially rational alternative is that an independent business would not enter into a similar arrangement, then the arrangement may be disregarded". We agree that prices should be arm's length but do not agree that this proposed threshold is appropriate.

In our view the appropriate test is whether a taxpayer would be "more likely than not" to have agreed such an arrangement with a third party. This should be specified in legislation.

Paragraph 5.39 states that the reconstruction rules would be limited to "exceptional circumstances", although not explicitly so. We believe the legislative provision should legislate for the "exceptional circumstances" if this is the intention. If the words "exceptional circumstances' are not appropriate then another description should be used. The description in paragraph 5.40 of "aggressive and commercially irrational" arrangements may be appropriate if these terms were defined.

Paragraph 5.40 of the Discussion Document encourages taxpayers to seek APAs to increase certainty. We appreciate the Government seeking to provide certainty to taxpayers given the inherent uncertainty of a reconstruction provision. However, for many taxpayers, obtaining an APA is not realistic. We understand from our members that securing an APA does not happen at the speed of commercial business – it is a long process, and often expensive. We understand from speaking to our members that many attempts to procure APAs are abandoned due to the length of time taken and none we spoke to had succeeded in obtaining a bilateral APA. If Inland Revenue wishes taxpayers to obtain greater certainty through APAs we believe it must act to make the process as streamlined as possible, including resourcing a large team dedicated to performing this work.

Arm's length conditions

We understand the reasons for the proposal to amend the legislation to refer to arm's length "conditions" rather than an arm's length "amount". In our view it is sensible to view the entire agreement rather than the price in isolation (and we understand this currently happens in practice).

However, the proposal again adopts the Australian approach which we believe would involve significant overreach. As with the "economic substance" proposal, this one is also based on section 815.130 of the Australian Income Tax Assessment Act 1997.

The full text of the section requires that one disregards the form of the arrangement to the extent that it is inconsistent with the substance and also provides (in subsections 3 and 4) as follows:

> " … if:
>
> 1. independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations; and

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2. independent entities dealing wholly independently with one another in comparable circumstances would have entered into other commercial or financial relations; and

3. those other commercial or financial relations differ in substance from the actual commercial or financial relations;

the identification of the *arm's length conditions must be based on those other commercial or financial relations.

(4)

Despite subsection (1), if independent entities dealing wholly independently with one another in comparable circumstances would not have entered into commercial or financial relations, the identification of the *arm's length conditions is to be based on that absence of commercial or financial relations."

As we have stated under "economic substance", above, in most cases is likely that the arrangement would be different if it had been entered into by a third party; it is also likely that the parties would not have entered into the arrangement had it had not been with a related party. Businesses do not always negotiate the best deal every time. Sometimes they simply need to move forward.

As we have stated under "reconstruction", above, we believe this this proposed threshold is uncommercial and therefore not appropriate. In our view the appropriate test is whether a taxpayer would be "more likely than not" to have agreed such an arrangement with a third party. This should be specified in legislation

Burden of proof

The document proposes the burden of proof be reversed for transfer pricing issues and be placed on the taxpayer. We understand this is also the position in Australia.

We appreciate the taxpayer has better information about their affairs than the Commissioner does. However, we understand that the reason for the burden of proof being on the Commissioner in transfer pricing cases is due to the nature of the issues involved. Transfer pricing issues are often matters of judgement. The Commissioner and taxpayers use benchmarks and comparables to show that the arrangement is "arm's length". The Commissioner has access to the tax records of every taxpayer in New Zealand, and has access to offshore information from overseas tax authorities, so can be in the best position to determine whether the arrangement is similar to one that has been entered into elsewhere.

We do not believe the burden of proof should simply be reversed. If the burden is to be shifted to that taxpayer then, at the least, the burden should be on the Commissioner in situations where she is using data that is not available to the taxpayer.

__Transfer pricing documentation__

We understand most multinational enterprises over the proposed turnover threshold provide this information already and we do not have a problem with the requirements being formalised in legislation.

We agree compliance costs will be low because most or all affected taxpayers undertake this work currently. Compliance costs can often be an issue in transfer pricing requirements and we believe the proposal is smart and pragmatic.

__Time bar__

The Discussion Document proposes that the time bar for transfer pricing assessments be increased from four years to seven years, noting that this would be consistent with other jurisdictions.

The table on page 37 gives information on the time bars for ten other countries. Of these, Australia and Canada have the four year / seven year split; all others seem to have the same or a similar time bar for transfer pricing matters as for other tax matters. Given this, we do not believe that consistency with other jurisdictions is, in itself, a reason to make the change.

We understand Officials' concerns regarding the complexity of modern commercial arrangements but in our view these concerns should be addressed by increasing resource to investigate and deal with arrangements at the time they occur. We do not believe spreading the work over an additional three years to be a useful solution.

Increasing the time bar also seems inconsistent with the direction Inland Revenue is heading in its customer-centric approach. We understand one of the goals of the Business Transformation project is to provide more "real time" advice, information and assurance. A key aim is to encourage taxpayers to "get it right from the start".

In addition, Inland Revenue's compliance management approach for multinational enterprises has been to move to resolving any issues with commercial transactions in real time. It is doing this by providing more pre-filing reviews and risk reviews. In our view this is working well. The time bar has remained at four years but many taxpayers are now able to achieve practical certainty within one year.

The proposal to move the time bar for transfer pricing to seven years is out of step with and other Inland Revenue initiatives and, in our view, is a retrograde step.

If this move were to go ahead it would be imperative that the change were prospective only – i.e. would include only transactions and documentation from when the change were enacted and not documentation from six years ago.

__Applying the transfer pricing rules to investors acting in concert__

We understand Officials' wish to align the "associated persons" rules for thin capitalisation and transfer pricing.

However, we are concerned that, as a practical matter, many minor investors would not be involved in

transfer pricing decisions and would not have access to transfer pricing documentation. They would rely on the decisions of the major investors. We believe the rule needs to be flexible to allow for this possibility.

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Chapter 6: Administrative measures

The new administrative measures proposed generally provide more incentives for taxpayers to comply with Inland Revenue requirements and more sanctions when they do not comply. We question whether the new administrative measures are needed when most multinational enterprises cooperate with Inland Revenue. However, if such measures are to be implemented, we agree that this should be done by way of legislation and not by reliance on administrative practice.

It is our view that any increase in administrative sanctions must be accompanied by corresponding measures to encourage and assist taxpayers to comply.

In practical terms, this means initiatives to give taxpayers certainty that they are doing the right thing, such as greater access to rulings; real time Commissioner's opinions; greater access to earlier signoffs via risk reviews; and assistance from Inland Revenue – from staff or a website – when required. As we have previously discussed, the Inland Revenue restructure provides an opportunity for the Commissioner to redeploy resources to areas where they will be most needed going forward.

In addition, in our experience, most multinational enterprises cooperate with Inland Revenue and so we question the need to introduce new administrative measures to encourage cooperation.

In terms of the specific proposals, we do not agree that Inland Revenue should have the power to unilaterally fine taxpayers for not providing information. Fines should be imposed only by an independent body such as a court. If the Government wishes Inland Revenue to have the power to impose fines we believe, at the least, that this power should exist only with the signoff from an independent party such as a TRA judge, the Solicitor-General or the Attorney-General.

We would be happy to discuss our submission with you and look forward to the opportunity to do so.

Yours sincerely

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BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
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21 April 2017

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Transfer pricing and permanent establishment avoidance

We support the consultative approach adopted by the Government in its adoption of measures associated with the G20/OECD-led Base Erosion and Profit Shifting ("BEPS") project.

BEPS – Transfer pricing and permanent establishment avoidance forms part of an interconnected package, alongside *BEPS – Strengthening our interest limitation rules* and *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.* The package is a powerful combination, which will put New Zealand at the forefront of worldwide approaches to BEPS implementation.

This submission should therefore be read alongside our submissions on the other elements of the package.

Permanent establishment avoidance and amendments to source rules

We agree that economic activities which should result in a permanent establishment ("PE") in New Zealand should be subject to tax here. Nevertheless, the discussion document does not provide a compelling case for the adoption of measures in domestic legislation regarding PEs and source-based taxation.

In general, we support New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.[1] As elaborated in Appendix A, the multilateral convention is the best opportunity for a coordinated international approach, with significant risks inherent in New Zealand departing from international norms through the introduction of standalone rules.

New Zealand's position can be distinguished from that of Australia and the United Kingdom. Those countries' early action has had the effect that their equivalent rules will be in place for a period of several years before the multilateral convention applies: the impact of their rules includes being a transitional bridge for an interim period. New Zealand's later application means this argument has little force here.

[1] See our submission regarding *New Zealand's implementation of the multilateral convention to implement tax treaty related measures to prevent BEPS.*

Should New Zealand seek to introduce the PE and source rules proposed, it will be important that legislation be drafted with great clarity as to scope and application. Our experience in the United Kingdom and Australia shows that poorly drafted rules lead to disputes, with uncertain outcomes for taxpayers and deteriorating relationships between multinationals and tax administrations.
Further, if the rules are adopted, there should be a substantial lead time before they take effect. Multinational groups often structure their supply chain consistently across all operating territories. Restructuring will be complex and will require time.

As set out in Appendix B, we have a particular concern that amendments to the source rule overreach: they could tax foreign sourced income of non-residents in contravention of New Zealand's international tax framework.

Transfer pricing

We support better alignment with Australian transfer pricing rules given the high level of trans-Tasman investment and degree of business integration - but only to the extent those rules remain consistent with the principles set down by the OECD and do not seek to tax a greater than arm's length proportion of profit.

That means we support aligning transfer pricing rules with economic substance and giving Inland Revenue the power to reconstruct transactions. Reconstruction should, however, only be an option in exceptional circumstances and this, or similar, wording should be included in legislation. The Commissioner must not treat unsuccessful commercial decisions as irrational and our support is conditional upon appropriate safeguards to protect taxpayers.

It is important for any changes to be prospective, both in law and practice. It is not appropriate for Inland Revenue to apply the 2016 revisions to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") to transactions that occurred before the publication of the revised Guidelines.

If the taxpayer is to bear the burden of proof in relation to transfer pricing, we consider that Inland Revenue should be more prescriptive around what is required by way of evidence. Documentation requirements should be set out in some formal way (rather than through webpages on the transfer pricing section of Inland Revenue's website).

We see little justification for an extension to time bar for transfer pricing enquiries. New Zealand's current four year time bar is by no means out of step with other countries, with any extension running contrary to the real time approach adopted as a part of Business Transformation.

With the expansion of Inland Revenue's powers under the proposed transfer pricing rules, it will become more important for specific guidance to be available to taxpayers and advisors. Guidance would be welcome regarding documentation requirements, comparable and benchmarking, and the circumstances in which particular transfer pricing methods are favoured by Inland Revenue. This should be provided by way of detailed rulings or interpretation statements rather than informal website changes.

We expand these points in Appendix C.

Administrative measures

Collection of information in transfer pricing audits is time consuming and draws heavily on both Inland Revenue and taxpayer resources. We are not convinced that granting the Commissioner extensive additional powers will resolve the difficulties. Instead many of the proposed administrative measures could better be resolved by additional resourcing of Inland Revenue's transfer pricing and investigations teams.

Our comments on the specific measures proposed are provided in Appendix D.

Future engagement

The consultation period following release of the discussion documents has been short. To that end, our submission is intended to flag issues which we consider require further analysis, and, where appropriate make recommendations on the approach. We look forward to continuing to engage in discussion on the proposals throughout the coming policy-making and legislative stages.

We understand that these submissions may be the subject of a request under the Official Information Act 1982, and consent to the submissions being made publicly available.

We would appreciate the opportunity to discuss our submissions in person. Please contact David Snell (david.snell@nz.ey.com, +64 21 845 361) in this regard.

Yours sincerely

Aaron Quintal
Partner – Tax Advisory Services
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Appendix A – Permanent Establishment Avoidance

Multilateral instrument should be implemented before considering further permanent establishment reforms

We agree that economic activities which should result in a permanent establishment in New Zealand should be subject to tax here and support a rule which does not widen the accepted international definition of a PE in substance (paragraph 3.2).

New Zealand's implementation of the *Multilateral convention to implement tax treaty related measures to prevent BEPS* has the potential to address most, if not all, of these concerns. On this basis, we suggest efforts should focus on its implementation and resultant impact before introducing potentially wide ranging domestic PE and source reforms, with uncertain application.

Should that approach not be adopted, it will be of critical importance that legislation be drafted with great clarity as to scope and application. We are concerned that where the wording adopted is in any way ambiguous or uncertain this would lead to significant taxpayer uncertainty around the validity of global operating models and a significant increase in the number of disputes between taxpayers, Inland Revenue and other tax authorities.

We have a further concern that the proposals will not be consistent with our existing double tax agreement ("DTA") commitments and will therefore fail to work in practice.

Our concerns are driven by the experience to date with comparable rules in Australia and the United Kingdom. Our understanding is that uncertainty in the wording of the corresponding legislation in these territories has led to:

- A significant rise in the number of cross-border tax disputes.
- Concern among taxpayers that the Australian Tax Office and Her Majesty's Revenue and Customs are "cherry picking' arguments, leading to greater incidence of the rule being invoked than stated at the time of introduction. This is in contrast to a principled approach taking into account the underlying commercial substance of a given arrangement.
- Apparent administrative difficulties within the Australian Tax Office, evidenced by delays in providing guidance around its diverted profits tax.
- An increase in compliance costs, with costly restructuring imposed on global supply chains for little benefit to revenue authorities or multinationals.
- The threat of the legislation being used to compel taxpayers into costly and impractical changes to their operating models, notwithstanding that there may be strong technical support for the tax position.
- Consequent damage to the relationship and mutual trust between taxpayers and tax authorities.

Application of the rule (paragraphs 3.20 to 3.26)

If the PE avoidance rule is adopted, there should be a transitional rule to enable taxpayers to structure out of arrangements that would give rise to a deemed PE. Inland Revenue should provide guidance on the meaning of various new concepts which form part of the rule – notably "commercially dependent", "in connection with", "low tax jurisdiction", "high paid employee" and "specialised services".

Need for transitional rule (paragraph 3.20)

Paragraph 3.20 provides that the proposed rule will apply to income years beginning on or after the date of enactment. We submit there should be a transitional rule to enable taxpayers to structure out of arrangements that would give rise to a deemed PE. The rule should apply only with effect to income years beginning three years on or after the date of enactment, as reorganising global supply chains can be a complex business, with New Zealand unlikely to be central to many multinational enterprises' structures.

There will be taxpayers subject to these rules with existing investment structures that have previously been reviewed by Inland Revenue, in some cases perhaps having obtained rulings, tax audit sign-offs or Advance Pricing Agreements ("APAs"). Formerly compliant taxpayers should be given time to comply with any new rules.

In particular, it is common for multinational groups to structure their supply chain or operating model on a consistent basis across all operating territories. Restructuring in accordance with the proposed New Zealand rule will often not be as simple as amending New Zealand aspects and will often require fundamental change to global operations. This, by definition, has flow on consequences (commercial and tax) in a large number of territories and it follows that this is not something that can (or should) be undertaken quickly. It is considered inappropriate to impose such a short time frame for realignment (with the threat of 100% penalty if that timing is not met) for many or most taxpayers.

A related point is considered below in the "consequences of application" section of this submission regarding the imposition of a 100% penalty for currently compliant structures in the absence of grandparenting.

We have particular concerns that Inland Revenue may seek to assess companies planning to restructure ahead of these changes. There is a possible case for an Operational Statement regarding implementation. Otherwise companies will be unwilling to change arrangements as this could be seen as an admission of tax avoidance.

New concepts will require explanation (paragraphs 3.21 and 3.24)

Any legislation needs to be sufficiently clear in what it is intended to do to ensure taxpayers are capable of complying with it at a reasonable outlay of time and cost. In particular the legislation needs to clarify:

- The rule will apply where there is a related entity that is either "associated" or "commercially dependant (sic)" (paragraph 3.21). The discussion document does not provide in-depth analysis as to the meaning of "commercially dependent" - although this appears to be quite broad. There will be many situations where an entity is arguably commercially dependent on a major customer, even though the agent is independent. For example, would an independent agent who received over 50% of revenue from a single foreign entity be "commercially dependent" on that entity? The "commercially dependent" terminology could also pick up relationships such as independent

distributors whose business is limited to one brand, which we assume is not the intent of the rules. A car dealership would be an example of a commercially dependent, but independent, agent, albeit one likely already to have a taxable presence in New Zealand. Alternatively, is "commercially dependent" intended to be consistent with the dependent agent clause in New Zealand's DTAs? We note that New Zealand businesses, given its relatively small market size, could be particularly susceptible to triggering "commercial dependence" where this is sufficiently widely drafted to catch arm's length dealings with major or sole offshore customers. Given New Zealand business' unique bargaining position (or lack thereof) as a function of relative size, particular care should be taken to ensure this concept is not drafted so as to apply far more broadly than intended.

- The rule is to apply where a related entity carries out an activity in New Zealand "in connection" with a particular sale (paragraph 3.21). The discussion document does not address what constitutes "in connection". This is a broad term and may need more clarification. At present, it is unclear whether there must be a direct causal connection that actually brings about the sale or whether an indirect connection (e.g., any activity which facilitates the sale) is sufficient. We note Australia and the United Kingdom have taken different approaches to this issue, with Australia requiring a direct connection. We would suggest that the Australian "direct" connection approach should be favoured to ensure nebulous connections to sales activity cannot be caught by virtue or "mere" or ancillary connection.

- Indicators of a PE include the involvement of a "low tax jurisdiction" (paragraph 3.24). It will be important to define this term. Does "low tax jurisdiction" mean lower than 28%, 20%, 15% or other? Many corporate tax rates have fallen in recent years, with the United Kingdom currently at 20% but scheduled to fall to 17% in 2020 one example. Is the tax base, as well as rate, a relevant factor? Proposals to introduce a border tax adjustment, combined with a reduced rate, could potentially bring the United States into any definition. There could also be issues regarding jurisdictions which have a low company tax rate but instead tax other bases (such as a resource rent tax or royalties), with state-level taxes, or with tax rate changes over time.

- PE indicators also include the existence of "a number of well paid employees". Clarity regarding what is meant by a "well paid employee" would be welcome. It can also be argued that a combination of well paid employees and low profits is a transfer pricing, rather than PE, issue.

- Finally, the term "specialised services" is unclear. What are "specialised services" and why is that indicative of a PE? Turning again to the concept of ancillary services, these are often highly specialised and it is suggested that often a high degree of specialisation would support significant separation from sales activity.

Arrangements involving third party channel providers (paragraphs 3.27 to 3.31)

More guidance is needed in respect of what would constitute "sales promotion and services"

The concept of "sales promotion and services" is crucial to the application of the rule to arrangements involving third party channel providers and should therefore by explained. For example, if a related party organises a tradeshow for a number of different suppliers, would this constitute "sales promotion and services"?

Consequences of application (paragraphs 3.32 to 3.39)

More guidance is needed on Inland Revenue's approach to profit attribution. Applying a 100% abusive tax position appears harsh given the lack of grandparenting for existing structures which fully comply with current law.

Paragraph 3.35 notes that profits attributable to the deemed PE will be determined by normal profit attribution principles. We have no issue with this statement, but Inland Revenue guidance on normal profit attribution principles is limited. If Inland Revenue were to apply a method different to that of a trading partner, then double taxation and further pressure on the mutual agreement procedure ("MAP") are likely outcomes.

That concern is reinforced by the statement in paragraph 3.36 that application of normal profit attribution principles will "result in a fairly significant amount of the sales income being attributable to the deemed PE" in most cases. It is not clear to us that this should be the outcome: if, as will often be the case, little value is added in New Zealand, then the attributed profit will be small. Expenses will also be attributed to New Zealand, rather than attribution being based on gross sales income alone.

As an obvious example, it would be expected that an unrelated New Zealand supplier, albeit one with a degree of "commercial dependence" or reliance on a dominant customer, would negotiate at arm's length to arrive at a remuneration level fairly reflecting its value additive functionality. We would be concerned were the proposed deemed PE rule seek to re-examine or recharacterise commercial economics negotiated by arm's length counterparties.

We also note that New Zealand would intend to impose withholding tax on any royalty paid by the non-resident in respect of supplies made through the deemed PE. Such a royalty may well relate in part to other supplies made by other jurisdictions. We anticipate that apportionment would be necessary, which would again be difficult to calculate. Detailed guidance as to an apportionment methodology would be necessary should this aspect by introduced.

Paragraph 3.38 states that the current 100% abusive tax position penalty will apply for the purposes of the deemed PE rule. This appears to be an unduly harsh penalty for arrangements which are in compliance with current law for which it is currently proposed that no grandparenting is available. We consider Inland Revenue is significantly underestimating the time it will take for a multinational enterprise to reorganise its global supply chain.

We note the comments in the discussion document around a significant "lead time" between now and the introduction of the law. Notwithstanding such lead time we emphasise that there is currently no draft legislation or certainty around the time gap between publishing such draft legislation and effective date of final law. It is unrealistic to assume or expect taxpayers to restructure global operating models on the basis of a discussion document given the inherent uncertainty of what the actual law will say and the significant global commercial implications such a restructure would have.

We recommend that the potential for grandparenting or non-application periods for particular taxpayers be revisited.

Interaction with New Zealand's double tax agreements (paragraphs 3.40 to 3.45)

> The proposed permanent establishment avoidance rules may be inconsistent with New Zealand's DTA network, thereby creating uncertainty, deterring investment and undermining confidence in New Zealand's DTAs.

We agree that taxpayers should not be able to rely on DTAs to protect tax avoidance relations. We are not convinced, however, that the proposed anti-avoidance rule will only capture arrangements which should be treated as avoidance arrangements for the purposes of our DTAs.

In fact, the breadth of the proposed unilateral approach is likely to reduce confidence in the integrity of New Zealand's double tax agreements and to create uncertainty for foreign investment into New Zealand. There is inherent inconsistency between the alignment with suggested OECD approaches to international taxation (including but not limited to the adoption of the multilateral convention, including an enhanced PE definition) and the introduction of New Zealand-specific deemed PE provisions such as that suggested.

In addition, the proposals are arguably inconsistent with the generally accepted OECD approach of separate entity taxation that applies in respect of associated enterprises and has been agreed to by New Zealand in all of its DTAs. It is unclear how the proposals will apply in relation to the interaction between deemed PEs and the operation of the arm's length principle in respect of existing related party transactions. The proposals could potentially apply to transactions to which no actual New Zealand taxpayer is party.

More specifically, the proposals would impose new tests that are inconsistent with New Zealand's obligations under various existing DTAs. Tax could potentially be payable where a multinational operates a business structure that complies with existing DTA concepts of PE, within integrity measures agreed in our treaties and which meets the legal substance requirements of both parties to the DTA.

Where this occurs, it is likely that double taxation will occur, with MAP invoked. It appears possible to us that competent authorities would rule in favour of treaty provisions and the proposal's purported domestic law override would be invalid.

This uncertainty would reduce the effectiveness of the proposals as a base maintenance measure, while worsening the impact of the measures on inbound investment. In substance, little revenue may be gained while substantial inbound investment using new or innovative business models may be deterred.

Appendix B – Amendments to source rules

Permanent establishment source rule has potential to overreach (paragraphs 4.18 to 4.22)

The permanent establishment source rule could tax foreign sourced income of non-residents, in contravention of New Zealand's international tax framework.

Income attributable to a PE and royalties that New Zealand can tax under a DTA will automatically be deemed to have a New Zealand source under the new rule.

While we understand that the intention in respect of this aspect is to ensure that there is not a "gap" between PE attributed income under New Zealand tax treaties and that may be taxed under our domestic source rules. However, it appears possible to us that such a rule could be indeed be drafted so as to deem, for example, a New Zealand source for the foreign-sourced income of non-residents. Taxing such income would be inconsistent with New Zealand's longstanding international tax framework and would go significantly beyond the stated purpose of the amendment. A DTA should not be used to create a tax liability where none would exist under domestic law.

The PE definitions contained in individual treaties will be used for the purposes of this rule (paragraph 4.19). Before final decisions are made on the design of the source rule, it would be helpful for Inland Revenue to analyse the definitions of PE across our treaty network, as we anticipate these will contain significant differences around, for example, building sites (6/12 months), natural resources, standing timber, or operating substantial equipment. Industry specific guidance may be helpful, as some sectors (such as film or technology) are particularly subject to disputes regarding PE status and income source.

Anti-avoidance source rule (paragraphs 4.23 to 4.28)

There is a risk that the anti-avoidance source rule will extend to situations beyond those targeted by the OECD BEPS Action Plan.

We have no objection to a targeted anti-fragmentation and contract-splitting rule, consistent with the OECD's BEPS measures aimed at countering PE avoidance strategies.

The risk is that a rule treating the non-resident's income as having a source in New Zealand if it would have had a source, considering the non-resident's wholly owned group as a single entity will go beyond an anti-fragmentation rule. We consider that where a non-resident is earning income that has no domestic source there should be no tax. This is not a PE avoidance issue as in the absence of a New Zealand PE there is no need to even refer to the DTA. If drafted too broadly, it could seek to tax not only the New Zealand sourced income of the PE but also income derived by other group members with a New Zealand source where those other group members have no PE here (in effect, a "force of attraction" approach). We do not anticipate this is the intent but would welcome clarity on this point.

Life insurance source rule (paragraphs 4.29 to 4.35)

The life insurance source rules should be changed by way of renegotiating the relevant DTAs.

While we understand what this proposed change is seeking to achieve, we consider this would be better achieved by a change to the relevant DTAs rather than via domestic law creating another boundary for life insurers to navigate.

Appendix C - Transfer Pricing

Broad support for direction of reform

We broadly supports better alignment of New Zealand transfer pricing rules with Article 9 of New Zealand's DTAs and the OECD Guidelines, which are an aid to interpret Article 9: Associated enterprises). Better alignment with Australian transfer pricing rules makes sense given the significant investment by Australian companies and to mitigate the potential for double taxation – but only to the extent those rules remain consistent with the principles set down by the OECD and do not seek to tax a greater than arm's length proportion of profit.

Transfer pricing definition (Paragraphs 5.7 to 5.9)

At paragraph 5.7, the document states that transfer pricing is a strategy used by multinationals to "shift profits out of New Zealand and reduce their worldwide tax bills". We are concerned this interpretation indicates a mind-set that multinationals generally target New Zealand taxable income through their transfer pricing strategy, which overstates the significance of New Zealand in global terms and understates the rigour imposed by the arm's length principle.

Transfer prices rules are defined in the 2016 revisions to the OECD Guidelines[2] as being concerned with determining the conditions, including the price, for transaction within an MNE group resulting in the allocation of profits to group companies in different countries. Transfer pricing might therefore be more neutrally defined as the setting of those prices (whether or not that results in the shifting of profits or a reduction in worldwide tax bills). Multinational enterprises cannot help but engage in transfer pricing, the concept itself is not tax driven and should not be used in derogative terms.

The in-market distributor structure (paragraph 5.16 and Appendix)

> The in-market distributor structure given in example 4 is overly simplistic. It leads to an interpretation that the Government considers all distributors with low profits to be problematic, where they happen to be performing distribution activities for a procurement hub in a jurisdiction with a lower corporate tax rate.
>
> Inland Revenue should clarify that using a limited-risk distributor ("LRD") has commercial justification. Use of the example without additional necessary factual information (e.g., regarding the risks actually borne by the respective parties) otherwise creates uncertainty.

Paragraph 5.16 of the discussion document refers to example 4 in the appendix, which relates to the use of an in-market LRD in New Zealand.

The LRD model is one commonly used throughout the world, including in New Zealand. It is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development ("R&D") happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken in New Zealand happens at the end of the supply chain and is often relatively low in terms of the value-adding functions contributing to the system profits of the enterprise.

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[2] Executive summary, *Aligning transfer pricing outcomes with value creation:* OECD Final report on Actions 8-10.

OECD Guidelines (Chapter IX) recognise the LRD model and that companies may convert from full risk to limited risk models. Of course, consideration needs to be given to risk allocation and the revisions proscribe more emphasis on the economic substance of the structure. The structure should not be viewed as lacking “commercial reality”[3] simply because it is not a structure commonly seen between independent parties - yet the trade-off of risk and return is a fundamental commercial principle.

At paragraph 5.31, the discussion document quotes the revised OECD Guidelines as endorsing a substance-over-form approach to the allocation of risk. Viewed in isolation, this paragraph might suggest that contractual assumption of risk is not relevant to a transfer pricing analysis. However, the OECD Guidelines confirms that the contractual terms are the starting point in “delineating” a transaction, but not the only consideration.[4]

We endorse OECD’s initiatives to ensure that transfer pricing outcomes are consistent with the location of value creation. We also support that under BEPS Actions 8-10 revisions, structures will need to be tested to ensure the pricing aligns with the economic substance of the transaction. However, the discussion document’s commentary on the LRD structure is broad and is concerning in its wholesale designation of the LRD model as a form of profit-shifting (paragraph 5.16).

The implication seems to be that, in most cases, LRDs structures lack commercial reality and most risks are controlled by the New Zealand entity. Our experience is that invariably a substantial proportion of market risk is assumed and indeed controlled by the foreign principal (or other affiliates offshore). More often, marketing strategy is conducted offshore and tight control maintained over marketing spend, inventory levels and major business decisions of the LRD. The New Zealand subsidiary will often undertake market activation activity rather than development.

State of the law and reference to the OECD guidelines (Paragraphs 5.19 to 5.23)

> We support adding a reference to the OECD Guidelines into New Zealand’s transfer pricing legislation but dispute this reference will “simply clarify our existing practice”: it is not clear that Parliament intended the OECD Guidelines to be used as an interpretative aid to existing rules.
>
> Any law change to incorporate the OECD Guidelines should be prospective - both in law and in practice. It is not appropriate for Inland Revenue to apply the 2016 revisions to the OECD Guidelines to transactions that occurred before the publication of the revised Guidelines.

At paragraph 5.23, the discussion document states the OECD Guidelines are “generally consistent with our existing law” and that “Adding a reference to the OECD guidelines into New Zealand’s transfer pricing legislation will simply clarify our existing practice of using the latest guidelines”. We have previously argued in disputes with Inland Revenue that the current transfer pricing rules are not aligned with Article 9 and therefore some aspects of the OECD Guidelines do not sit well with the current New Zealand transfer pricing rules (similar to Australia following the decision in the *SNF*[5] case). While much of the OECD Guidelines are useful in assisting to interpret the arm’s length principle under New Zealand transfer pricing law, there have been some areas of controversy caused by the non-alignment, notably around the extent to which arm’s length prices should be subject to interpolated arm’s length conditions. We do not agree that the OECD Guidelines can simply be referenced as an authority under current law. Inland Revenue practice of using the OECD Guidelines will not be

[3] Appendix, Example 4, page 51.
[4] See paragraph 1.78 of the revisions to section D.1.2.1.2 of the OECD Guidelines.
[5] Commissioner of Taxation v SNF (Australia) Pty Ltd [2011] FCAFC 74.

consistent with the existing transfer pricing law in all circumstances. It should be clear that any law change to incorporate the OECD Guidelines is prospective - both in law and in practice.

We have concerns that some of the 2016 revisions to OECD Guidelines brought about through Actions 8-10 are already being referenced by Inland Revenue for years prior to 2016. Concerns centre on the focus on economic substance, despite the discussion document confirming that existing transfer pricing legislation is focused on the legal form of arrangements (paragraph 5.15). We are not comfortable with Inland Revenue's current practice of applying all the 2016 revisions to the OECD Guidelines to preceding years. Such practice is applying changes retrospectively.

This is of further concern given we do not consider OECD Guidelines fully align with existing transfer pricing law, as noted above. The BEPS initiatives in Actions 8-10 are a substantial revamp of the OECD Guidelines and the revisions made in 2016 to the OECD Guidelines should not be applied retrospectively. A taxpayer cannot be expected to forecast substantive changes to OECD Guidelines when determining tax positions prior to 2016. Taxpayers take tax positions based on the information available to them, and it is unreasonable for Inland Revenue to challenge these tax positions armed with hindsight and a set of guidelines that never existed at the relevant time.

In support of our concerns regarding Inland Revenue's approach towards incorporating the OCED Guidelines, we refer to legislative history. The current transfer pricing rules were substantially enacted by the Income Tax Act 1994 Amendment Act (No. 3) 1995, and came into effect at the beginning of the 1996/1997 income year.[6] The rules effectively legislated the arm's length principle which had long since been a feature of Article 9 of New Zealand's double tax agreements ("DTAs"). In turn, the DTAs are largely modelled on the OECD Model Tax Convention.

Our domestic legislation in fact makes no reference to the OECD Guidelines. Parliament's original intention[7] was for the five available methods set out in section GC 13 to be consistent with the then OECD Guidelines (first released in 1995). Parliament did not, however, choose to make explicit reference to the OECD guidelines. Without explicit reference in the legislation, it is not clear how the 2016 OECD Guidelines are relevant for the purposes of the New Zealand transfer pricing rules.

We note that the position of the OECD Guidelines is unique in that they are not binding on member states of the OECD, and have not been ratified in domestic New Zealand law. The extent to which Inland Revenue uses them as an extrinsic aid to the legislation, assisting in the interpretation of section GC 13, is questionable. It is not supported by the legislation itself which provides no indication of how the five available methods are to be interpreted.

Since the passing of the legislation, the OECD Guidelines have expanded and changed considerably, most recently through the implementation of Actions 8-10 and 13 of the OECD's BEPS project. The drafters of section GC 13 could not have foreseen the changes that have since taken place.

As shown by the legislative history of section DB 34 regarding research and development,[8] it seems unlikely that Parliament would have contemplated the Income Tax Act 2007 be interpreted in light of

[6] Tax Information Bulletin [1210-110] *Arm's Length Principle*, 1 October 2000.
[7] Set out in the commentary on the Taxation (International Tax) Bill, August 1995.
[8] Section DB 34 which allows a deduction for expenditure incurred on research or development where that expense has been recognised for financial reporting purposes. Section DB 34 not only refers explicitly to the relevant reporting standard but has been consistently updated to reflect changes in generally accepted accounting practice and in the specific reporting standards. Notably, changes have been made in the Taxation (Business Taxation and Remedial Matters) Act 2007 and the Taxation (Consequential Rate and Remedial Matters) Act 2009. The failure of Parliament to consider incorporating specific reference to the OECD Guidelines materially weakens any Government arguments that the Guidelines should be seen as a strong aid to interpretation of section GC 13.

whatever guidance OECD produce on a prospective basis. Parliament did not delegate responsibility for New Zealand's transfer pricing rules to OECD officials; rather, it took note those in place at the date of enactment in the design of New Zealand's rules.

Aligning the rules with economic substance (paragraphs 5.24 to 5.33), requirement for arm's length conditions (paragraphs 5.41 and 5.42)

We agree with the proposed changes to align the rules with economic substance. This reflects a step-change in the law and drafting of the legislation should set out unambiguously what is required of taxpayers, in order to demonstrate that all conditions of their transfer pricing arrangements are arm's length.

We have no issues with aligning the rules to economic substance in principle. In most respects the rules are already aligned to economic substance; present transfer pricing analyses necessarily involve preparation of a functional analysis.

However, reference to "arm's length conditions" would considerably broaden the scope of section GC 13. Inserting a rule to specify that taxpayers are required to take into account the relevant conditions that a notional third party would be willing to accept is likely to have a subjective and uncertain impact on many arrangements. While the Commissioner is entitled to make enquiries in assessing arm's length terms and conditions, a commercial negotiation will take into account many factors. Given that the burden of proof will fall on taxpayers to show that the conditions of their arrangements are arm's length, it is important that Inland Revenue is clear about what is required of taxpayers.

Reconstruction of transactions (paragraphs 5.34 to 5.40)

We submit that the test under which the Commissioner should be able to reconstruct transfer pricing arrangements must have a high threshold, consistent with the OECD Guidelines. New Zealand's legislation should refer to "exceptional circumstances" or provide similar wording that ensures it is only used where the arrangement is aggressive and/or commercially irrational. Adjustments which propose to reconstruct transactions should have a high level of sign-off internally within Inland Revenue, in the same way as our domestic avoidance laws. In conducting investigations, Inland Revenue looks at such arrangements retrospectively. It is important that the merits of any commercial decisions taken prospectively are not labelled irrational by the Commissioner who has the benefit of hindsight simply because they turn out to be unsuccessful. Inland Revenue should release robust guidelines to assist taxpayers on factors it will take into account in considering reconstruction; along with useful examples.

The discussion document proposes to grant Inland Revenue a wider mandate to reconstruct arrangements than that contemplated by OECD, similar to that adopted in Australia. According to paragraph 5.39, the proposed reconstruction rules would not be explicitly limited to "exceptional circumstances". Dropping the "exceptional circumstances" condition (which exists in the OECD Guidelines[9]) suggests that Inland Revenue would seek to reconstruct a transaction if a taxpayer cannot "benchmark" those particular dealings against those seen in the market between independent parties. We have concerns that taxpayers will be required to demonstrate that such dealings occur between

[9] D.2.1.121-125.

unrelated parties and the transaction is "commercially rational". Non-recognition or reconstruction will inevitably result in more international disputes and need for international dispute resolution.

The revised OECD Guidelines emphasise the problems inherent in reconstruction. Specifically, paragraph 1.123 of the revised part D.2 of the OECD Guidelines states:

> *"Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should be noted again that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement."*

Given the serious risk of double taxation, we consider that reference should be made in the reconstruction rules to be explicitly limited to exceptional circumstances. New Zealand's reputation as a good place for doing business depends in part on fair and certain regulation.

Wording along the lines of the Australian rules, i.e., that "independent entities dealing wholly independently with another in comparable circumstances would not have entered into the actual commercial or financial relations" will create considerable uncertainty for taxpayers. This is because this wording does not take account of the fact that associated enterprises do commonly enter into actual commercial or financial relations which would differ from those entered into by independent parties. It is only where the circumstances of such an arrangement are commercially irrational that the rule should be invoked. Section 1.123 of the revised OECD Guidelines states that the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties *under comparable economic circumstances, not whether the same transaction can be observed between independent parties.*

Paragraph 5.40 of the discussion document acknowledges that the rule will reduce certainty for taxpayers, but should only be the case where the arrangement is aggressive and commercially irrational. If that is the case, then we consider that the legislation should say so. If the concept of an "exceptional circumstance" is subjective, then perhaps some other word or phrase conveying the relevant meaning could be used.

Paragraph 5.35 of the discussion documents states that "if the commercially rational alternative is that an independent business would not enter into a similar arrangement, it may make sense to disregard (rather than reconstruct) the arrangement for tax purposes." This could present worrying outcomes. In most cases, Inland Revenue will be investigating retrospectively and would need to exercise caution that its conclusions as to whether an arrangement is commercially rational is not prejudiced by the benefit of hindsight, which a taxpayer entering into the arrangement would not have.

There is risk Inland Revenue will assert that an arrangement cannot be commercially rational simply because it is not seen in practice between unrelated parties. Inland Revenue needs to be cognisant of the important principle emphasised in OECD that cautions tax authorities to take into account that multinationals often enter into transactions that are rarely encountered between by independent parties.

Further, we note that disregarding an arrangement entirely should be rare. If an arrangement giving rise to a deduction is considered to be commercially irrational, the relevant counterfactual might not be the lack of any deduction at all. It might be that, but for the arrangement, the taxpayer would have entered into an alternative, commercially rational arrangement, which might have yielded a lesser deduction. Disregarding the arrangement entirely would therefore be unjust. We defer to the revised

OECD Guidelines which provide additional guidance as to when arrangements should be disregarded, and note that these examples are limited in scope (see for example, those at section D.2.).

Advance Pricing Agreements

APAs should remain unaffected by any law change until such time as the APA is required to be renewed.

While the proposed law changes will be prospective in effect, this could well impact APAs that have been negotiated and signed under the current law, yet will be subject to any law change.

Given that APAs, by their nature, are approached in good faith by a taxpayer to get certainty for a period of time, all APAs should remain unaffected by any law change until such time as the APA is required to be renewed.

Burden of proof (paragraphs 5.43 to 5.48)

If the taxpayer is to bear the burden of proof in relation to transfer pricing, we consider that Inland Revenue should be more prescriptive around what is required by way of evidence. Documentation requirements should be set out in some formal way (rather than through webpages on the transfer pricing section of Inland Revenue's website).

The risk of arrangements being reconstructed or disregarded (and deductions being denied) is serious for taxpayers who, under the proposals, bear the burden of proof in relation to showing that the conditions of their associated party transactions are arm's length. We submit that Inland Revenue will need to provide some guidance about what evidence should be provided. The proposed rules will necessarily increase compliance costs, with more robust transfer pricing documentation required.

The discussion document notes at paragraph 5.48 that the additional compliance costs imposed by a shift of the burden of proof would not be substantial. That may be so if the burden of proof was the only change. However, coupled with the need for taxpayers to show that all conditions of their cross-border associated party transactions are arm's length, the risk that Inland Revenue could reconstruct their cross-border arrangements and other measures such as the extended statutory time bar, the compliance costs for taxpayers will be substantial. We envisage that these proposals will add considerable expense for multinational companies and will likely increase the occurrence of disputes with Inland Revenue.

The additional expense might be mitigated if Inland Revenue set out more clearly what is required from taxpayers and what is not. Documentation supporting *all* conditions of a transfer pricing arrangement could encompass an almost unlimited amount of analysis. Inland Revenue would need to consider which conditions it deems to present more material risk, and what taxpayers must do to demonstrate that any given condition is appropriate.

One specific area on which guidance from Inland Revenue would be helpful is that of the use of the profit split method.

The OECD's Revised Guidance on Profit Splits[10] states at section C.3 that *"the application of a transactional profit split of actual profits reflects a relationship where the parties either share the same economically significant risks associated with the business opportunity or separately assume closely related risks associated with the business opportunity and consequently should share in the resulting profits or losses".* In particular, profit splits are deemed to be more appropriate where multiple parties make unique and valuable contributions such as unique and valuable intangibles.[11]

We are concerned that the increasing transparency over a taxpaying group's entire supply chain in transfer pricing matters and information-gathering powers given to the Commissioner in the proposals will lead to Inland Revenue increasingly seeking to use the profit split method for New Zealand taxpayers in circumstances beyond those envisaged by the OECD.

We are finding in practice that, in obtaining more information about the group's supply chain, Inland Revenue is proposing using the profit split method where we would not have considered it appropriate. We are concerned that, using additional powers to force taxpayers to pay tax early, Inland Revenue could devise profit splits using somewhat arbitrary calculations based on visibility of the group's global supply chain (and where the role of the New Zealand entity in that supply chain is neither particularly unique nor valuable). Not only is Inland Revenue's use of the profit split method sometimes problematic, the resulting calculations regarding attributable profit can often be unsustainable. For example, a technology company is unlikely to have been able to allocate losses to New Zealand in its development phase, so application of the profit split method as soon as profits eventuate can lead to inequitable outcomes. Further guidance is needed from Inland Revenue on its use of the profit split and other methods; in practice we consider that its use can often be contrary to the relevant OECD guidance.

General requirement to document transfer pricing practices (paragraphs 5.60 to 5.63)

> We submit Inland Revenue should provide guidance to taxpayers on when transfer pricing documentation needs to be prepared, and what the documentation ought to contain.
>
> One approach would be to provide some de minimis rules to allow taxpayers to prepare simplified documentation, along the lines of the simplified record keeping requirements in Australia. Taxpayers with a small amount of related party transactions should be able to take a cost/risk approach to documentation without concern of a potential shortfall penalty.

Multinationals often ask us whether transfer pricing documentation is required by New Zealand legislation, whether there are monetary thresholds for preparing transfer pricing documentation, and what the penalties are for non-compliance. These questions are driven by taxpayers' experience in other jurisdictions, where the legislation clearly sets out these matters. In New Zealand the answer is less clear, because:

- Transfer pricing documentation is not explicitly required by legislation, but rather in practice required by Inland Revenue as evidence that taxpayers have exercised reasonable care;

- Monetary thresholds for which documentation is required are not explicitly stated; rather Inland Revenue considers that transfer pricing documentation should reflect the level of risk (without stating what level of risk is material)[12];

[10] Issued 5 September 2016.
[11] See section C.3.2.
[12] See paragraphs 317ff of the New Zealand transfer pricing guidelines.

- Penalties are calculable with respect to any tax shortfall (not whether transfer pricing documentation has been prepared at all), for example where the taxpayer has not taken reasonable care.

New Zealand's self-assessment regime therefore places a larger burden on taxpayers to determine for themselves whether their cross-border associated party transactions are material, and the level of documentation that is appropriate. Some multinationals are not well-equipped to determine what the New Zealand Government would deem to be material. What is material for one revenue authority can be insignificant for another.

Further, multinationals often determine their transfer pricing obligations centrally. They must enquire into the transfer pricing rules of a large number of jurisdictions, and require straightforward answers as to what level of documentation is required in each. If the requirements are vague and complex, as they arguably are in New Zealand, on a cost/risk basis the multinational may decide only to prepare transfer pricing documentation for those countries whose law explicitly requires it.

At paragraph 5.61, the discussion document is critical of the varying quality of documentation prepared by taxpayers. In our experience, multinationals generally prepare their transfer pricing documentation consistent with the OECD Guidelines. Inland Revenue has not specifically stated what it would like to see included in transfer pricing documentation. It did produce its own transfer pricing guidelines (the "IRD Guidelines").[13] However, it has now stated its intention not to further update the IRD Guidelines and instead follow the 2010 OECD Guidelines.[14] This begs the question: what would Inland Revenue like to see in the documentation (other than what the OECD Guidelines prescribe)?

In summary, the present transfer pricing rules do not adequately describe to taxpayers:

- How the arm's length standard is to be interpreted and how the five available methods should be applied (i.e., whether the OECD Guidelines are authoritative, and if so, which version);

- When taxpayers are required to prepare transfer pricing documentation to comply with the law;

- What documentation should contain so as to satisfy the Commissioner that the taxpayer has taken reasonable care in determining its transfer prices.

Inland Revenue is not proposing any compulsory filing of transfer pricing documentation. It will expect transfer pricing documentation, such as a master file and local file, to be provided on request or audit. Experience in Australia under its new transfer pricing laws is that the level of document compliance has increased. Given alignment of the transfer pricing rules with those of Australia, and the concerns we express above, the Government should consider providing some de minimis rules to allow taxpayers to prepare simplified documentation, along the lines of the simplified record keeping requirements in Australia. Taxpayers with a small amount of related party transactions should be able to take a cost/risk approach to documentation without concern of a potential shortfall penalty.

[13] An appendix to *TIB* Volume 12, No 10 (October 2000).
[14] See for example: http://www.ird.govt.nz/transfer-pricing/transfer-pricing-guidelines.html.

Time bar extension (paragraphs 5.67 to 5.72)

We oppose the extension of the time bar for transfer pricing matters. The fact-specific nature of a transfer pricing dispute is neither unique to transfer pricing nor justification for the extension.

The discussion paper suggests that an extended time bar would bring New Zealand in line with other jurisdictions. The paper points to Australia and Canada which have time bars that are three years longer than their four year time bars for other tax matters. We note from the table given at paragraph 5.70 that there are several other jurisdictions which have the same time bar for transfer pricing as they do other tax matters; so New Zealand is by no means out of step with the world.

The discussion document seeks to draw a distinction in relation to transfer pricing assessments which are more dependent on the facts and circumstances of each case than other tax matters. Other tax matters also are dependent on facts and circumstances; the avoidance regime would be one example where factual inquiries are more necessary and yet the time bar remains the same.

It should also be noted that a longer time bar creates the same difficulties for a taxpayer trying to defend its tax position as it does for the Commissioner. This is particularly pronounced where, for example, the taxpayer has since restructured or closed their New Zealand operations and there are no longer staff in New Zealand with institutional knowledge of the taxpayer's operations.

Further, the extension of the time bar would be inconsistent with Inland Revenue's other moves towards real-time tax compliance. It is contrary to the scheme and purpose of Inland Revenue's Business Transformation programme. We also note that participation in the Inland Revenue's APA programme has been strong in recent years, reflecting a willingness on the part of both the Commissioner and taxpayers to settle transfer pricing matters contemporaneously, rather than engage in costly and lengthy disputes.

Many other changes are proposed in the discussion document which assist the Commissioner in assessing multinationals on their international tax obligations. We consider that implementation of the statutory time bar could be deferred until the full effect of the other proposals is seen.

If the proposed extension of the time bar does go ahead, it should not unfairly reopen any previously closed periods. For example, tax positions assessed in the year ended 31 March 2013 will now be time barred, but could be reopened for a further three years unless any change is prospective.

Inland Revenue should provide more substantive rulings and guidelines to assist taxpayers

Inland Revenue should provide some specific guidance to complement OECD Guidelines in the New Zealand context. This guidance should be in the form of detailed rulings or interpretation statements rather than informal website updates. Guidance would be particularly important regarding suitable comparables for benchmarking, and the circumstances in which Inland Revenue views particular methods such as profit split as the most reliable transfer pricing method.

Although not specifically covered in the discussion document, with more complexity and uncertainty in Action 8-10 revisions, we urge Inland Revenue to prepare detailed rulings, interpretation statements or similar guidance in consultation with transfer pricing practitioners. The Australian Tax Office typically assists taxpayers by preparing rulings and other interpretation statements for their transfer pricing

rules (for example TR2014/6 relating to section 815-130). These rulings tend to provide explicit justification for departures from OECD Guidelines and follow a transparent consultative process with an opportunity for taxpayers and advisors to submit their views.

Inland Revenue released final transfer pricing guidelines in October 2000[15] but has ceased updating them. It has more recently relied on website updates, which contains relatively scant detail, have unclear authoritative value, are not widely publicised and may be removed from the website at any time. To ensure better compliance and less controversy, with these changes in law, we recommend Inland Revenue provide some specific guidance to complement OECD Guidelines in the New Zealand context.

Fundamental to the OECD Guidelines is comparability. Difficulties in benchmarking comparables for New Zealand companies typically requires taxpayers to seek comparables in geographies outside New Zealand. Inland Revenue has previously suggested (via EY Global transfer pricing surveys) a hierarchy of geographies in terms of reliability of comparables (e.g., Australian companies have traditionally been considered the best geography to search for comparables and Asian countries the least). More recently we have noticed in practice Inland Revenue has been presenting benchmarking based on a wide geographical spread of comparables contrary to previously stated guidance. Further written guidance would be useful to minimise risk of dispute.

The administrative measures proposed in chapter 6 of the discussion document will give Inland Revenue more power to seek information held offshore about a multinational group’s affairs and to apply sanctions for non-cooperation. We acknowledge the need for Inland Revenue to be able to collect sufficient information in a timely manner to audit transfer pricing matters, but do have concerns about how the information is used. In particular, and as referred to above, visibility of a multinational group’s global supply chain is not in itself adequate justification for the use of the profit split method. The additional administrative measures therefore confer a responsibility on Inland Revenue to provide some robust guidance on transfer pricing matters, including use of the profit split, so that taxpayers can ensure that they are meeting Inland Revenue’s expectations of transfer pricing analysis and documentation.

[15] Tax Information Bulletin, Vol 12, No 10, October 2000, appendix

Appendix D - Administrative measures

Cooperation and resourcing (paragraphs 6.1 to 6.18)

We submit that many of the proposed administrative measures could better be resolved by additional resourcing of Inland Revenue's transfer pricing and investigations teams. The administrative measures proposed would give the Commissioner substantial powers to issue an assessment and avoid many formalities of the existing disputes process. We consider that these powers overreach in light of the other proposals advanced, such as the shifting of the burden of proof to taxpayers.

We acknowledge that collection of information in transfer pricing audits is time consuming and draws heavily on both Inland Revenue and taxpayer resources. In practice, most multinationals are cooperative with Inland Revenue: it is in their interest to resolve disputes quickly and with certainty. In our experience, Inland Revenue as well as the taxpayer will cause delay. Delays are caused by lengthy periods waiting for Inland Revenue to respond and information requested proving not to be of much assistance to Inland Revenue, thereby requiring alternative information to be requested. We suggest some protocols and guidelines be put in place, agreed with transfer pricing practitioners, around transfer pricing audits so taxpayers can also be assured that matters will be dealt with expediently and Inland Revenue positions reached within a reasonable period of time, with reasonable clarity and with least possible disruption to the taxpayer group.

The majority of problems noted above could be resolved through resourcing. Powers to gather more information will worsen transfer pricing administration unless Inland Revenue is able to deal with that information on a timely basis.

We are concerned that resourcing issues will be exacerbated by the implementation of other proposals in the BEPS package. In particular, we consider that interaction of the interest rate cap and transfer pricing rule changes will lead to a larger number of cross-border disputes, double taxation and MAPs. We are concerned that Inland Revenue will not have sufficient resources to devote to these requests and procedures. It would be concerning if the Commissioner uses her new administrative powers to push seemingly “uncooperative” taxpayers further into the disputes process due to a lack of available resources at the investigation end.

Assessments (paragraphs 6.19 to 6.20)

Should the proposal for Inland Revenue to issue a NOPA or assessment based on information available at the time proceed, a taxpayer should be able to challenge that assessment.

At paragraph 6.19, the discussion document proposes that Inland Revenue be able to issue an assessment based on the information available to Inland Revenue at the time. As a drafting matter, it seems likely that this would need to be added as an exception to section 89C of the Tax Administration Act 1994, which provides the circumstances in which the Commissioner may make an assessment without first issuing a notice of proposed adjustment (“NOPA”).

Further, we note that, all other things being equal, section 138E(1)(e)(iv) would operate to ensure that there would be no right of challenge against a decision of the Commissioner. This is concerning given the potential gravity of a taxpayer being caught by the rule and having an assessment made against them. The proposal could be seen as draconian given that the Commissioner's decision would not be reviewable. Other than that it would need to be signed off by a senior member within Inland Revenue,

there seem to be few safeguards to stop Inland Revenue issuing an assessment based on relatively subjective criteria.

Payment of tax in dispute (paragraphs 6.21 to 6.26)

We submit that this measure should not proceed:

- Large multinational enterprises are unlikely to default on tax due
- At current rates, use of money interest will not compensate taxpayers should Inland Revenue's position not be confirmed

Should our main submission be declined, purchases of tax from a tax pooling service should be accepted as payment of tax.

It is important to consider the position of a taxpayer against whom an assessment is issued under the new rules. In such a case, the taxpayer would have to challenge the assessment in Court. Even if it succeeds, it would then only receive the Commissioner's paying rate of interest on the tax recovered. Given that the Commissioner initiated the dispute the current rate of 1.02% per annum[16] this effectively penalises the taxpayer through no fault of its own.

The purpose of the use of money interest regime is stated in section 120A of the Tax Administration Act and includes compensating taxpayers for the loss of use of money through their paying too much tax. Further, interest payable under the regime is not a penalty.

The proposals only affect large multinationals with revenue of over EUR750 million. Generally these taxpayers do not default on tax payments. Yet, under the current disputes regime, the Commissioner can recover interest at the taxpayer's paying rate which reflects a higher credit risk than these types of taxpayers actually represent to Inland Revenue. It is unclear why upfront payment of tax would really be necessary for these taxpayers when the use of money interest regime already adequately compensates the Commissioner.

Further, no reason has been advanced for why purchases from a tax pooling services should not be accepted as payment of the relevant tax. Denying pooling as an option seems to support that the use of money interest regime is in fact being used to impose a penalty rather than incentivise the correct payment of tax. We submit that purchases of tax from a tax pooling service should be acceptable.

Collection of information (paragraphs 6.29 to 6.37)

We submit that section 21 should have an exception for information which is subject to legal privilege.

Drafters of the legislation will need to take particular care in relation to the expansion of section 21 of the Tax Administration Act, as described at paragraph 6.37 of the discussion document. One concern is the position of tax advice which is subject to legal privilege. In some circumstances, the Commissioner will request information from a taxpayer in a section 21 request and the taxpayer might have legally privileged advice which arguably falls within the ambit of the request. In such a case, the taxpayer should not be required to disclose the document, but not doing so might affect its ability to later waive privilege should it wish to use the documents as admissible evidence in court.

[16] From 7 May 2017

Deputy Commissioner, Policy and Strategy
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1 May 2017

BEPS – Transfer pricing and permanent establishment avoidance

Dear Deputy Commissioner

Thank you for the opportunity to comment on the Discussion Document (DD). We appreciate that targeting base erosion profit shifting to ensure multinationals are paying an appropriate level of tax in New Zealand is a key focus for the Government.

We have a number of comments that we would like Officials to consider as part of the design of the proposals. A summary of our submission points is as follows (all of which we discussed with Officials in our recent meetings), with more detail provided in the Appendix:

- the application date for any new policy changes should be the income year commencing after 31 March 2019 (or equivalent non-standard tax years) at the earliest;
- the proposed rule around permanent establishment avoidance (New PE Rule) should adopt the wording used in Article 13 of the Multilateral Instrument;
- if the New PE Rule is to override tax treaties, this needs to be clear in the legislation;
- there needs to be clarity in the concepts and drafting around where the line is drawn between marketing services etc that are not intended to be captured by the New PE Rule and sales activity that is intended to be captured;
- there needs to be more clarity around the other elements of the New PE Rule;
- urgent guidance is needed from Inland Revenue in relation to attribution of profits to the deemed PE;
- the biggest risk of the New PE Rule is that multinationals may decide to exit NZ if the uncertainty and tax risks are too high;
- there should be a post-implementation review within 3 years of enactment;
- 100% penalty for abusive tax position should not automatically apply if the New PE Rule applies;
- royalties deemed to have a NZ source may be subject to double withholding tax;
- Inland Revenue resourcing for transfer pricing matters needs to be increased;

- more guidance is needed from Inland Revenue in a number of areas related to transfer pricing;
- the time bar for transfer pricing should not be extended to 7 years;
- new administrative measures should not apply from enactment to disputes already in progress;
- "non-cooperation" needs to be clearly defined and have a higher threshold than the bullet point summary in the DD suggests;
- imposing an obligation on a NZ subsidiary to pay a multinational's tax is too harsh;
- tax pooling should be available to multinationals in relation to any new payment rules;
- it may be difficult for a NZ subsidiary to demonstrate adequately it has discharged its obligation to provide information requested of its parent; and
- section 21 of the Tax Administration Act 1994 needs to be rewritten to more closely accord with the current Inland Revenue practice and intention.

As discussed with Officials, we would appreciate the opportunity to review and comment on draft legislation before it is released as part of a Bill, if possible, in particular wording around the scope of the New PE Rule and the definition of a non-cooperative taxpayer.

We trust you find our comments useful. If you have any questions, please contact us.

Yours sincerely

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Appendix: Detailed Submissions

1. Application dates

Application date should be no earlier than 1 April 2019

We understand that targeting BEPS is a key focus for the Government and an early enactment date may be its preference. In our view, the proposed application date should be no earlier than the first income year after 31 March 2019 (or the equivalent non-standard tax years). The proposed changes will affect a significant number of taxpayers, and not just those who may be viewed as having adopted unacceptable tax practices. It is reasonable to allow taxpayers time to consider how best to deal with these issues, and to rearrange their affairs if they decide it is necessary. It will be in the interest of continued investment from overseas to allow properly for this.

2. PE avoidance proposal

The New PE Rule should adopt the wording used in Article 13 of the MLI

We understand Officials' concern is that multinationals are currently able to structure their tax affairs so that they are subject to no or very little tax in NZ despite carrying on significant economic activity here. From discussions with Officials, we understand that the scope of the New PE Rule is not intended to be wider in scope than the changes to NZ's double tax agreements (DTAs) to be implemented by Article 13 of the Multilateral Instrument. This policy intention is also stated in paragraph 3.2 of the DD, where Officials say that "the proposed rule is not trying to widen the accepted international definition of a PE in substance".

The best way to ensure that this scope is matched in a domestic context, is to adopt word for word the OECD standard for dependent agent permanent establishments (PEs) used in Article 12(1) of the MLI. That wording has already been through a rigorous process of negotiation between jurisdictions and an extensive submissions process on a global basis, and has been refined to ensure that the language is not wider than the OECD considers it should be. The MLI will also provide the new global standard for when a source country will have taxing rights in relation to a non-resident, and taxpayers will have a greater amount of certainty as to the scope of the New PE Rule if the global standard wording is used. Whilst we understand that Officials have some concerns about how some aspects of the MLI wording will be interpreted, the benefit of global consistency and clarity around how the rule will operate should outweigh these concerns. Furthermore, existing anti-avoidance rules can be used to address any residual concerns.

If the New PE Rule is to override tax treaties, this needs to be clear in the legislation

Regardless of the drafting approach preferred, it should be made clear in the legislation that the New PE Rule is not wider in scope than the widened PE definition under the MLI – in other words, it should be clear that a non-resident in a jurisdiction which has a treaty amended by the MLI will not have a permanent establishment (PE) under NZ domestic law if it does not have one under the relevant treaty (as amended by the MLI). This approach is consistent with paragraph 3.2 of the DD. We do not think that the concerns raised in paragraph 3.45 arise in a situation where the relevant treaty partner has adopted the widened definition of PE under the MLI.

In cases where a treaty is not amended by the MLI, a non-resident will have a PE under NZ domestic law, but absent specific provision in the NZ legislation, the treaty will override this result so the non-resident will not have a PE. If the intention (per paragraph 3.45 of the DD) is that the New PE Rule will override the treaty, this must be specifically provided for in NZ's domestic legislation to be effective.

There needs to be clarity around where the New PE Rule line is drawn between sales and marketing activity

In principle it sounds simple to refer to sales activity being within the New PE Rule but marketing/support activity being outside. However, in reality there is a spectrum of customer relationship activity and it may be far from clear where the line will be drawn as to whether particular activities will result in the new rule applying, or whether identified activity leads to a particular sale or not. At its broadest, any activity carried on by a subsidiary in NZ could be argued as intended to lead to sales of the multinational's product or service in NZ. Furthermore, there may be a number of activities carried on both inside and outside NZ that lead to a particular sale. Is it the activity which is most influential in leading to a particular sale, or is it any activity in NZ which can be connected to a particular sale, that matters? What if the NZ account manager is generally responsible for a customer's account, but it is not clear whether the activity of the account manager is what leads to a sale of a particular product?

For example, will the following multinationals have a deemed PE in NZ under the New PE Rule?

- a multinational that has a NZ subsidiary, whose staff are contracted to visit existing and potential customers and explain contractual terms, but refer customers to the multinational's website for orders of goods on standard terms;
- the multinational's NZ subsidiary has initial and ongoing contact with customers, but at a certain stage of negotiations for a particular sale refers customers to multinational's foreign sales force and legal team, which discuss in detail the customer's needs and negotiate the sales contract;
- a multinational who has technical support staff in NZ, who occasionally refer a customer directly to the multinational for a sale of a particular product; or
- a multinational who deals in high value goods where heads of terms for sales contracts are negotiated locally but detailed terms of contracts are entered into directly by a group member in another jurisdiction.

Inland Revenue should provide detailed guidance and examples around when the new rule is intended to apply. The OECD guidance in this area is not particularly helpful and we understand Officials acknowledge this issue too. We see this issue as a key area of uncertainty.

There needs to be more clarity around the other requirements of the New PE Rule

Further explanation is required around a number of the other elements of the New PE Rule. For example:

- What does "commercially dependent" mean? Guidance should be provided here as to what Officials have in mind.

- It does not make sense for qualification criteria to refer to some or all of the profits not being attributed to a NZ PE – if the non-resident already has a PE, it is not necessary for the new rule to deem a PE to exist – rather, any issue should be around profit allocation.
- What is the "purpose of the DTA's PE provisions", and how will this criteria apply when a non-resident is not resident in a treaty country? It would be preferable for any language here to follow language in existing anti-avoidance provisions, such as section BG 1 of the Income Tax Act 2007. Introducing a new standard for a concept that relates to avoidance will create unnecessary uncertainty and complexity for taxpayers and Inland Revenue, and it may take many years before its meaning is conclusively established.
- What is the distinction between an "unrelated independent agent" referred to in paragraph 3.22 and not caught by the New PE Rule, and an "independent third party" referred to in paragraph 3.27 who is caught by the rule? Is the meaning of "independent party" the same in both cases, with the scope of the rule determined by the activities of a non-resident or a related entity, or do the independent parties have different features in each case (e.g. is an independent party within paragraph 3.27 nonetheless managed or controlled by the non-resident)?
- How does a third party within paragraph 3.27 differ from a commercially dependent entity referred to in paragraph 3.21?
- It may be difficult to distinguish in practice between independent agents, commercially dependent entities, and third party channel partners – it would be helpful for the distinguishing features of each arrangement to be set out in more detail.
- Should it be clear that publicly traded third parties are independent agents/third parties in all cases?
- If the third party referred to in paragraph 3.27 carries out sales activity with respect to a particular sale to a consumer, does this mean the New PE Rule would not apply?Further guidance should be provided as to what particular services a related entity might provide that would be relevant – for example, services that include locating a customer, promoting products to that customer, discussing the customer's needs, tailoring a product to a customer, and indicating pricing, delivery dates and other key terms to the customer.
- It would be helpful to establish the scope of the new rule if the legislation contained features of arrangements that Officials consider to be indicators of PE avoidance.

Urgent guidance is needed in relation to attribution of profits to the deemed PE

Our understanding is that Officials view the intended outcome of the New PE Rule as being to match tax paid in NZ by multinational groups with the economic value created by the activity carried on in NZ. This outcome can be achieved if a group enters into a buy/sell model whereby a NZ subsidiary buys products from an offshore group member and on-sells to NZ customers. If the NZ subsidiary pays a royalty to an offshore group member, this is recognised for NZ tax purposes, subject to the application of usual transfer pricing principles, with the result that the taxable profit in the NZ subsidiary properly reflects the value created by that subsidiary's activities (which are in many cases in NZ limited to routine sales functions).

However, it is uncertain how the intended outcome can be achieved in the context of profit attribution to a PE given that NZ does not endorse the Authorised OECD Approach to profit attribution. The main benefit of the Authorised OECD Approach is that it is possible for profit attribution to properly match economic value by treating the non-resident and its PE as separate entities, and therefore allowing internal arrangements, to be recognised (such as an appropriate royalty to be allocated to the branch from the head office from internally generated intellectual property). In contrast, NZ's current approach permits only actual costs incurred by the non-resident to be attributed to a NZ PE. The amount of profit subject to NZ tax can therefore be disproportionate to the activity of the PE because value attributed to intellectual property generated offshore may be taxed in NZ. This is the wrong outcome and is not in accordance with our understanding of the desired policy basis for the New PE Rule. Furthermore, this outcome does not align with the proposed changes to the transfer pricing rules, which are intended to base NZ's tax rules on economic substance rather than legal form.

We acknowledge that this issue already exists. However, there are currently relatively few PEs recognised in NZ in this scenario so the issue is limited in practice. It will become much more relevant if the New PE Rule is enacted. It is therefore essential that Inland Revenue assists taxpayers by releasing more detailed guidance in this area.

This guidance will be particularly important in the case of:

- "large" multinationals who may be at risk of being seen as uncooperative under the administrative measures proposed by the DD if they do not provide sufficient information to determine the profit attributable to a PE; or
- "large" multinationals and their wholly owned NZ subsidiaries, who may be required to pay disputed tax early under the DD proposals related to payment and collection of tax in dispute, even if the multinational cooperates with Inland Revenue.

A big risk of the New PE Rule to NZ is that multinationals may exit NZ

Uncertainties around the scope of the deemed PE rule and profit attribution are likely to lead multinationals to restructure their affairs so the new rule does not apply (as has been the experience in Australia following the enactment of their Multinational Anti Avoidance Rule). There are fundamentally 2 ways in which a restructure can occur:

(a) the non-resident and its NZ subsidiary could enter into a buy/sell model, where the NZ subsidiary buys product from the non-resident on arm's length terms and sells to NZ customers; or

(b) The non-resident could wind up its NZ subsidiary and either (i) not sell product in NZ, or (ii) sell product in NZ directly from overseas with no group employees in NZ.

This outcome is consistent with the policy outcome identified in paragraph 3.39 of the discussion document. However, in light of the relative size of the NZ market compared to global operations of the multinationals this rule is likely to affect, and time and cost involved in restructuring, (b) is the more likely scenario. The risk is that the multinational will exit from NZ altogether – we have had preliminary discussions with some multinationals who have indicated that this is likely to be their solution if the New PE Rule is enacted. Officials need to consider whether it is an acceptable risk that foreign investment into NZ will be reduced.

100% penalty for abusive tax position should not automatically apply

Simply having a deemed PE under the new rule should not be enough to trigger a penalty for taking an abusive tax position. If the multinational's view is that the group has already returned taxable income in NZ equivalent to the economic value of activities conducted in NZ, it is not appropriate for such a penalty to be imposed.

There should be a post-implementation review within 3 years of enactment

We would recommend a post-implementation review within 3 years of enactment. Given the OECD work programme and similar domestic law changes being made in other countries, any new law should be measured against necessity and inconsistencies with other jurisdictions, and whether it has resulted in unintended consequences for business and Inland Revenue, such as multinationals exiting their investment into NZ.

Amendments to the source rules

Royalties deemed to have a NZ source may be subject to double withholding tax

A royalty paid by a non-resident to another non-resident may be subject to foreign withholding tax. If all or part of a royalty is deemed to have a NZ source, and is therefore subject to NZ withholding tax, the royalty will be subject to withholding tax twice. Relief would not be available under a DTA. Officials should reconsider whether this is acceptable tax policy.

Strengthening the transfer pricing rules

Inland Revenue resourcing for transfer pricing matters should be increased

In our experience, Inland Revenue's transfer pricing team is significantly under-resourced. This leads to frustration for taxpayers because risk reviews, audits and advance pricing agreements (APAs) take a long time and are very expensive for taxpayers, and a lack of regular correspondence with Inland Revenue while matters are ongoing typically exacerbates the issue of uncertainty. We currently have several unilateral APA applications held up with Inland Revenue that were submitted more than 24 months ago. This is in stark contrast to Inland Revenue's 6 month timeframes for APAs.

These frustrations will only increase under the strengthened transfer pricing rules, particularly if the time bar is extended. A better solution, and one more in line with Inland Revenue's business transformation project, would be to ensure that Inland Revenue is properly resourced (with adequately trained transfer pricing specialists) to provide guidance as to expected timeframes, and to consistently respond within these timeframes.

If the transfer pricing rules are strengthened as proposed (particularly with respect of the timebar extension and change in the onus of proof), it will become critical to ensure that Inland Revenue is able to provide certainty through the APA process in a timely and efficient manner. Accordingly, we recommend the introduction of strict timeframes for Inland Revenue to respond to APA applications to ensure taxpayers can obtain certainty as to process and cost, as well as certainty as to tax treatment of transactions in addition to substantial increases in transfer pricing specialised resources within Inland Revenue.

More guidance is needed from Inland Revenue in a number of areas related to transfer pricing

Inland Revenue needs to provide guidance in the following areas to help taxpayers comply with their obligations and manage their risk:

- What information does a taxpayer need to obtain to be able to discharge the onus of proof? For example, what exact level of documentation will be required? Many taxpayers may form a reasonable view on the arm's length nature of their dealings without formally preparing documentation – will this be possible going forward? Or will it only be possible through the preparation of full transfer pricing documentation in line with the OECD's recommended Masterfile/Localfile approach?
- This issue will be particularly important in the case of large multinationals, who may be at risk of being seen as uncooperative under the administrative measures proposed by the DD if they do not provide sufficient information to determine the arm's length amount of a related party transaction.
- Will there be simplification measures to ensure the compliance burden does not outweigh the tax at risk in relation to smaller taxpayers or those with low-risk structures? For example, will standard practice or more de minimis safe harbours be introduced? We strongly recommend these types of measures be considered.
- What are expected timeframes for risk reviews, audits and APA negotiations?
- Will there be a period of transitional measures or relaxed enforcement following enactment of the new rules especially in circumstances where taxpayers have existing APAs under existing structures that may be impacted by the changed in the transfer pricing rules.
- Will the Inland Revenue be providing clear detailed guidance as to the limited circumstances where the Commissioner can reconstruct a related-party transaction. We strongly recommend it is made clear that this power will only be exercised by the Commissioner in extremely limited circumstances (and guidance as to what type of circumstances could be impacted). This power is essentially giving the Commissioner the ability to tell a taxpayer how to conduct its business commercially which clearly will not be appropriate in almost all cases.

The time bar for transfer pricing should not be extended to 7 years

The transfer pricing time bar should not be extended for the following reasons:

- If Inland Revenue's transfer pricing team was properly resourced, it would be possible to deal with disputes and other matters within the 4 year time bar already provided for in NZ's legislation. NZ is a small market, and it should be possible to deal with all matters within the 4 year time bar. A survey performed by the OECD's Forum on Tax Administration revealed that the average resolution for transfer pricing cases (amongst 43 OECD and non-OECD countries) was 540 days. The proposed time limit of seven years is more than four times this average, which seems unjustifiable in the NZ context. Whilst Australia and Canada allow for 7 years, most other countries have a shorter period.
- As Officials recognise, extending the time bar will decrease certainty for taxpayers, and will not promote efficiency in transfer pricing disputes. It will also prolong transfer pricing disputes, and

the costs of disputes will increase. These effects are not in the interests of either Inland Revenue or taxpayers.

- The extension of the time bar in combination with the administrative measure requiring large multinationals to pay tax within 12 months of a NOPA being issued or 90 days of an assessment means that Inland Revenue has little incentive to resolve the dispute in a timely way. The multinational (or potentially a wholly owned subsidiary in NZ) may be out of pocket for a significant period of time if the dispute is resolved in a way which means the multinational is entitled to a refund. Retaining the time bar at 4 years will give the parties a better incentive to resolve the dispute more quickly.
- Taxpayers will be required to obtain all information necessary to support their positions on an annual basis through the tax return process. We are not aware of any compelling justification as to why Inland Revenue needs a longer period than the 4 years already provided for to consider transfer pricing matters.
- Whilst we acknowledge that it is possible to seek certainty through APAs, in practice APAs are very expensive and take a long time to obtain, generally due to delays with Inland Revenue due to resourcing constraints (as per our example set out above).
- If a transfer pricing dispute is resolved in favour of Inland Revenue, the group will be at risk of double tax in jurisdictions where the time bar has already passed. This is because the group will not be able to claim a corresponding adjustment in the other jurisdiction. This outcome makes NZ appear less attractive for a non-resident considering whether to continue investment in NZ.
- There will be also commercial consequences to the extension. For example, a vendor selling a NZ company generally gives a tax indemnity to the buyer lasting around 5 years. If the time bar is extended, the buyer will no doubt seek to obtain a tax indemnity of around 8 years. This will significantly extend the time period for tax risk faced by the vendor. Furthermore, if the vendor seeks to mitigate its risk through indemnity insurance, it will need to obtain insurance cover for the extra time period, which will result in an increase in premium costs.

If the time bar is extended:

- as mentioned above, the detrimental effect on taxpayers must be negated by improvements in the APA process for obtaining certainty; and
- exemptions for small and medium sized entities and for NZ entities investing overseas should be considered.

Administrative measures

New measures should not apply from enactment to disputes already in progress

In fairness to taxpayers, the new administrative measures should not apply to disputes in progress, or there should be transitional rules.

Non-co-operation needs to be clearly defined and of a high threshold

The concept of significant and persistent non-cooperation needs to be of a sufficiently high threshold to justify the consequences. Our view is that instances of non-cooperation should be specifically

connected to failures to meet legal obligations imposed in the tax legislation – a taxpayer should not be treated as non-cooperative if it does not respond to a non-binding informal information request, or a request that is outside the ambit of the specific provisions. Furthermore, behaviour should be able to be objectively assessed, and based on clear guidelines provided by Inland Revenue.

Some of the circumstances listed in paragraph 6.16 of the DD do not seem appropriate to trigger non-cooperativeness. For example:

- a taxpayer may not be legally obliged to respond to Inland Revenue correspondence in some situations – if so, non-response should not be non-cooperative behaviour;
- failure to provide sufficient information to determine an arm's length amount or profit attribution to a PE will require a subjective assessment by Inland Revenue – it seems unreasonable for non-cooperation to arise in such a case.

Consequences which follow from transfer pricing and profit attribution issues highlight the need as mentioned above for clear and urgent guidance from Inland Revenue to ensure taxpayers are aware of the standards required for compliance.

Imposing an obligation on a NZ subsidiary to pay a multinational's tax is too harsh

It is not clear in the DD whether the proposal applies to all tax payable by a large multinational, or just tax arising in relation to disputes listed in paragraph 6.24. In either case, imposing what could potentially be a large tax liability on a NZ subsidiary that may have limited assets or resources seems disproportionate. Furthermore, imposing such a liability on a subsidiary may have other adverse effects on the subsidiary such as breaching loan covenants, breaching thin capitalisation requirements, and, if a subsidiary is sold, increased risk for a vendor under a tax covenant.

If this obligation is introduced, it should only arise in circumstances where the multinational is non-cooperative and has not met its payment obligations under law. Furthermore, the subsidiary should not have an obligation to pay its parent's disputed tax early as proposed in paragraph 6.22.

It will also be necessary to consider how the obligation on a NZ subsidiary to meet its parent's tax liabilities interacts with directors' duties under sections 131 to 137 of the Companies Act 1993. We are aware of at least one instance where Inland Revenue has sought to recover unpaid tax liabilities from the directors of a company that could not meet its liabilities on the basis that directors had breached their duties.

Tax pooling should be available

There is no explanation in paragraph 6.24 regarding why tax pooling would not be available to a multinational with payment obligations under the proposals, and this does not seem justifiable when considering the purpose of tax pooling. Officials should give this issue further consideration.

It may be difficult for a NZ subsidiary to adequately demonstrate it has discharged its obligation to provide information requested of its parent

We understand from Officials that it is not intended that employees of a NZ subsidiary can be convicted of an offence of failing to provide information about an offshore group member. This should be clear in the legislation.

In many cases, it may be difficult for a NZ subsidiary to obtain the information required from its parent. Furthermore, it may be difficult for a NZ subsidiary to demonstrate that the overseas entity does or does not have the information.

Section 21 of the Tax Administration Act 1994 needs to be rewritten

If section 21 is to be extended as proposed, it needs to be rewritten as a whole to be more balanced and reasonable to taxpayers.

The consequences of section 21 applying are severe. Section 21 excludes a taxpayer's right to access the courts (through the exclusion of challenge rights) and also excludes a taxpayer's rights to use relevant evidence in challenge proceedings. This effectively means that, where this provision is invoked, an assessment can be treated as final, without the ability to challenge the assessment for its correctness. This is a significant limitation of taxpayer rights and should only occur in the most serious cases.

As section 21 is currently drafted, the mere failure to respond adequately to an information request may be sufficient to trigger the severe consequences set out above. There is no requirement for a taxpayer's failure to be significant or persistent, which means that this provision is inconsistent with the other provisions proposed in the DD.

In our view, section 21 should be rewritten to ensure that the severity of the consequences are appropriately matched by the significance and persistence of a taxpayer's non-co-operation and failure to provide information. As the consequences are more severe than the other measures proposed in the DD, the legislative threshold for its application should be higher.

#008

26 April 2017

BEPS – Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir/Madam

Submission on Discussion Document: BEPS – Transfer pricing and permanent establishment avoidance

The following submission has been prepared by AMP Capital Investors (New Zealand) Limited (AMP Capital New Zealand) on the Discussion Document: BEPS – Transfer pricing and permanent establishment avoidance. AMP Capital New Zealand is a specialist investment manager that manages a number of funds that are Portfolio Investment Entities (PIEs), as well as private equity investments.

Our submission focuses on the potential affect of the transfer pricing proposals contained in the discussion document on some of the investments that we manage on behalf of investors. We are not commenting on the permanent establishment proposals. However, this does not mean that we necessarily endorse the comments and outcomes reached by the Commissioner in the discussion document on permanent establishment.

Background

New Zealand has a broad base, low rate tax system with limited exceptions. We understand what you are trying to achieve which is ensuring that if economic activity occurs here that New Zealand collects tax. Thus where non-residents are carrying on business in New Zealand they should bear their share of tax. However, some of the proposals seem to go too far and will affect the majority of multinationals that you state operate in New Zealand and are tax compliant[1]. Our comments on the specific transfer pricing proposals set out in the discussion document are detailed below.

Economic substance

The proposal for transfer pricing practices to align with economic substance[2] moves New Zealand to a "would have test". Under the economic substance test taxpayers may have issues with obtaining relevant external facts that match for comparison to their circumstances. This is applicable to specific industries and distinctive fact taxpayers. This issue needs to be considered and workable solution found.

There also needs to be consideration on how Inland Revenue Officials will use and apply the economic substance test in the future. Views may shift over time which could result in detrimental effects on taxpayers. This could result in Inland Revenue with the benefit of hindsight assessing taxpayers based on better level of information than what was available at the original time. Safeguards need to built into any rules that introduce the economic substance test, to ensure that views or interpretation do not shift over time.

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[1] Page 2, point 1.8, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance
[2] Pages 29-30, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

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Reconstruction of transactions

The proposed transfer pricing reconstruction rules[3] comments that these rules will reduce certainty for taxpayers but this should only be in the case where the arrangement is aggressive and commercially irrational. There is no explanation on what would or could be considered arrangements that are aggressive and commercially irrational for the proposed reconstruction rules to apply. Further there are no details on what measures or how one measures aggressive and commercially irrational arrangements.

We are concerned that test for an arrangement being aggressive and commercially irrational appears subjective and dependant on Inland Revenue Officials. Further, we note the issue of Inland Revenue Officials understanding, awareness and comprehensive of commercial environments, specific industries and the structures in which different businesses operate. For example a lack of familiarity with the commercial and legal implications of managed funds. There need to be safety measures in any rules introduced to ensure that a lack of commercial comprehensive and familiarity does not trigger the application of the reconstruction rules to a taxpayer. Applying an exceptional circumstances test like Australia has to the application of the reconstruction rules, may assist with this.

If any reconstruction rules are introduced there needs to be clear legislation and guidance for both taxpayers and Inland Revenue Officials on:

- what is meant by arrangements that are aggressive and commercially irrational,
- what is measured and how it is tested, and
- Inland Revenue sign-off i.e. Deputy Commissioner to apply the reconstruction rules to a taxpayer.

Arms length conditions

It is proposed that the transfer pricing rules are changed to refer to arms length conditions. This would require taxpayers to take into account the relevant conditions that a third party would be willing to accept when determining an arm's length price[4]. The proposals do not consider the situations of there being no equivalent third party comparisons or data for a taxpayer to use and very limited publically available data. Further there are situations where associated cross-border entities may accept a lessor commercial deal in order to give a better overall outcome for the group e.g. keep a client. How would the types of situations outlined be considered by Inland Revenue? In particular, would Inland Revenue consider each scenario for group member in isolation or can or will the bigger commercial picture of the outcome for a group of entities be taken into consideration?

Burden of proof

It is proposed that the burden of proof for transfer pricing should be shifted to taxpayers, due to taxpayers being far more likely to hold the relevant information to support its pricing than the Inland Revenue or other parties[5]. If this proposal is adopted, then Inland Revenue Officials will need to:

- factor in their own preconceptions, biases and assumptions when taxpayers provide their facts, and
- be prepared to obtain from taxpayers an awareness and familiarity of commercial environments, industries and specialised taxpayer circumstances, and
- be aware of constraints that apply to taxpayer's and the implications of these restrictions. For example trustees or supervisors roles in managed funds.

There should be some sort of protection included into the updated transfer pricing rules that preserves presented or stated taxpayer's facts unless exceptional circumstances apply such as the application of the reconstruction rules.

Time bar

We question the need to extend the time bar on transfer pricing matters from the current four years to seven years given the Inland Revenue will have real time data from its international questionnaires and

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[3] Pages 30-31, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance
[4] Pages 31-32, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance
[5] Pages 32-33, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

transformation project. If there are issues resolving transfer pricing reviews surely it is more appropriate for Inland Revenue to buy in or hire more resources just like commercial operators are required to do, rather than changing the rules. Further obtaining resources with commercial and specific industry experiences could assist Inland Revenue. For completeness, we have experienced significant delays (over a year) in obtaining transfer pricing responses from Inland Revenue Officials. Thus not all delays in this area are taxpayer based and therefore any timing requirements should apply to both Inland Revenue and taxpayers.

There is no transition period mentioned in the extension of time bar proposals, the result of this means that periods that are currently statute barring will be reopened for transfer pricing purposes on application of this rule. This will create uncertainty for businesses as they have already assumed that particular years are statute barred. Further this would allow Inland Revenue the benefit of hindsight through applying the amended transfer pricing rules rather than using current transfer pricing rules for a further additional three years.

Master and local files

It is stated that master and local file transfer pricing documents are to be provided upon a request or audit[6]. There is no commentary about the reasoning's behind a request and the form a request should take. To ensure that there is no change in view from Inland Revenue in the future, it would be appropriate to codify the circumstances in which such a request for master and local files can be made and the form of that request.

Investors acting in concert

There are limited details on how investors will be determined to be "acting in concert" for transfer pricing purposes and in what way this proposal may work. There are no comments on whether other jurisdictions will be applying similar rules; is New Zealand out of step with the rest of the world? New Zealand is a capital importing country thus we need offshore investors for large capital intensive projects and private investments. There will be additional costs for non-resident investors under this proposal through the acquired New Zealand entities being subject to transfer pricing rules and possibly themselves. This is yet another barrier to get non-residents across before they will invest in New Zealand entities or projects.

Prima facie it appears that private equity managers may be pushed into assisting non-resident investors and New Zealand acquired entity's with their transfer pricing obligations in these circumstances. This is not a usual role for a private equity manager. The level of fees charged by private equity managers would need to reflect the time and effort spent on transfer pricing matters.

Non-cooperation

If the proposed rules are introduced about when a taxpayer is being regarded as non-cooperative, they need to clearly define non-cooperation, what is measured and how this is tested. In particular, around any materially misleading information as this appears a subjective test and dependant on points of views which can be different between Inland Revenue and a taxpayer. There needs to be clear guidance, transparent procedures and processes to ensure the application of this type of rule is fair to taxpayers and not subject to preconceptions, biases and assumptions.

Any rules introduced need to contain appropriate timeframes that apply to both the multinationals and the Inland Revenue. The Inland Revenues standard of four weeks to six weeks for businesses replying to their requests for information needs to be extended, to account for peaks in work flow.

Payment of tax in dispute

The proposal for tax to be paid earlier in a dispute by multinationals is justified by the statement that collection of tax can be delayed for several years and this provides an incentive for multinationals to prolong disputes. However, as previously noted Inland Revenue has delayed responding to taxpayers and in these circumstances this would unfairly penalise taxpayers. There is a cost to having funds tied up. If Inland Revenue are holding on to large amounts of disputed tax they should pay the market rate for the opportunity cost of taxpayers having to fund these amounts. Further, checks and balances would need to be put in place to ensure that any assessment of whichever disputed tax issued to a taxpayer has a solid basis behind it.

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[6] Page 34, point 5.58, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

No reasoning's have been provided to back up the statement that purchases from a tax pooling service would not be acceptable as the payment of tax[7]. What is the justification for why this type of payment should be excluded?

Collection of Information

The fact that the Inland Revenue is having issues with obtaining information about offshore multinational group members of taxpayers from other tax authorities should not be a reason for changing the powers of the Commissioner in this area. Instead Inland Revenue Officials should put effort into their working relationships with other tax authorities to ensure that they obtain the information or assistance they want. Further, this proposal would push information collection onto New Zealand taxpayers of multinational groups as "information would first be passed on to the relevant New Zealand taxpayer who would then supply this information to Inland Revenue"[8]. There is a cost impact for taxpayers under this proposal.

Inland Revenue seems to be propositioning taking on an international policing role under this proposal, is this appropriate?

Please feel free to contact the writer on [redacted] if you would like to discuss any of the points outlined above.

Yours sincerely

Adele Smith
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T [redacted]
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[7] Page 43, point 6.24, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance
[8] Page 44, point 6.33, Discussion Document BEPS – Transfer pricing and permanent establishment avoidance

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#009

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27 April 2017

BEPS – Transfer pricing and permanent establishment avoidance
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON

Dear Cath

BEPS – TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE

We are writing to submit on the Government Discussion Document, *BEPS – Transfer pricing and permanent establishment avoidance*, (the "discussion document"). In particular, our submission relates to the proposed changes to the life insurance source rules (the "proposed changes").

We appreciate the opportunity to submit on the discussion document and would be happy to meet with Officials to discuss any of the matters raised in this submission further.

Summary

We submit that:

- The proposed changes place an onerous and unfair burden on New Zealand life insurers to have completeness of information regarding a non-resident reinsurer's place of tax residence and/or whether the non-resident reinsurer has a New Zealand permanent establishment. This seems a disproportionate response to what we would regard as a remote risk.

- Double tax agreements ("DTAs") operate to, among other things, protect a company from the risk of double taxation. A unilateral change to domestic legislation can deny a company the ability to rely on a DTA for protection from double taxation. The proposed change to deny deductions to a New Zealand life insurance company, represents an unfair and unilateral reconstruction of the tax treatment of life reinsurance and gives rise to what is in effect a double taxation, with no ability to rely on the relevant DTAs or the protection mechanisms within those DTAs. The appropriate response to this risk would be to amend the relevant DTAs.

- The proposed changes could have significant adverse economic implications to the tax treatment of existing life reinsurance contracts (where the reinsurer is resident in Singapore, Canada and Russia, and does not have a New Zealand permanent establishment) and unfairly penalises New Zealand reinsured life insurance companies. Life insurance reinsurance agreements are typically long term agreements. New Zealand life insurance companies will typically not be in a position to renegotiate such agreements part way through the term of the agreements. Therefore, should the proposed changes proceed, they should be restricted to life reinsurance contracts entered into after the enactment of the changes with reinsurers who are resident in Singapore, Canada and Russia and who do not have a permanent establishment in New Zealand. The rules should not apply for existing contracts or for contracts where the reinsurer, subsequent to entry into the reinsurance contracts, changes its tax status by losing its permanent establishment in New Zealand and/or becomes resident in Singapore, Canada or Russia.

Life insurance source rules

Article 7 of New Zealand's DTAs provide relief to non-residents such that, broadly, New Zealand is prevented from taxing business profits earned by a non-resident unless they are attributable to a permanent establishment in New Zealand. However, New Zealand DTAs (with the exception of New Zealand's DTAs with Canada, Russia and Singapore) specifically exclude income from insurance with non-resident insurers from this Article.

Therefore, in most cases, New Zealand has a taxing right on any life insurance contract which is entered into or offered in New Zealand by a non-resident life insurer. However, New Zealand's DTAs with Canada, Russia and Singapore do not exclude income from insurance so a non-resident life insurer in those jurisdictions (with no permanent establishment in New Zealand) will not be subject to New Zealand taxation on life insurance contracts entered into or offered in New Zealand.

Proposed changes to life insurance source rules

Officials concern seems to be that there may be tax relief for New Zealand sourced insurance income if the reinsurer is resident in Singapore, Canada or Russia, and does not have a permanent establishment in New Zealand. In response to this concern, the discussion document proposes the following amendments to the Income Tax Act 2007:

- *Section DR 3*
  The section is to be amended to specifically provide that no deduction is available for the reinsurance of policies if the premium income on that policy is not taxable in New Zealand (including under a DTA).

- *Section EX 28*
  The definition of a FIF included in the section is to be amended to specifically provide that New Zealand residents are subject to the FIF rules in respect of policies that are not subject to New Zealand tax under the life insurance rules or any applicable DTA.

Essentially, the proposed changes seek to deny deductions for the reinsured party in circumstances where the reinsurance premium income is not taxable in New Zealand (due to DTA relief provided to reinsurers under New Zealand DTAs with Canada, Russia and Singapore).

Adverse impact of the proposed changes

New Zealand life insurers cannot be expected to have completeness of information regarding a reinsurer's place of tax residence or whether the offshore insurer has a New Zealand permanent establishment. The proposed drafting places an unfair burden on the New Zealand life insurers to confirm the tax residence of the reinsurer. If the reinsurer is resident in Canada, Russia and Singapore, the New Zealand life insurer may not be in a position to renegotiate their reinsurance contracts. Furthermore, a reinsurer's tax status can change during a contract. It is unfair to penalise an insured part way through a contract by denying deductions for premiums.

Proposed changes are contrary to international tax principles

In general, double tax agreements ("DTAs") operate to allocate taxing rights between contracting states. One of the objectives of DTAs is to protect a company from the risk of double taxation. Double taxation occurs when two jurisdictions seek to tax the same source of income. Where this occurs a company can often rely on a DTA to protect them from tax in one of the jurisdictions. DTAs also provide mechanisms, such as the mutual agreement procedure ('MAP'), for countries to determine which country has the right to tax income.

Despite DTAs, a unilateral change to domestic legislation can deny a company the ability to rely on a DTA for protection from double taxation. In particular, if a country denies a tax deduction for a particular expense, where that amount is taxable abroad effectively gives rise to double taxation.

We would submit the proposed change to deny deductions to a New Zealand life insurance company, represents an unfair and unilateral reconstruction of the tax treatment of life reinsurance and gives rise to what is in effect a double taxation. The result of this change also leaves a NZ life insurance company, subject to these changes, with no ability to rely on the relevant DTAs or the protection mechanisms within those DTAs. We would also submit that the appropriate response to this risk would be to amend the relevant DTAs.

Grandparenting

The current tax treatments of reinsurance contracts have no doubt informed decisions taken when entering into existing insurance contracts. While uncertainty and risk is of course inherent in any long term agreement, particularly over an extended horizon like that used for life reinsurance contracts, we consider that it is a legitimate expectation of life insurer that they should be able to continue under reinsurance arrangements for the remainder of their terms without being subject to significant changes in tax policy.

Therefore, we submit that it is important that grandparenting treatment is adopted such that reissuance arrangements that existed before the enactment of the proposed changes are not subject to them. Furthermore, effective grandfathering treatment should apply if the tax status of the reinsurer changes during the contract.

For any queries in relation to this submission, please contact Teresa Farac (+64 9 303 0845 or tfarac@deloitte.co.nz).

Yours sincerely

TFarac.

Teresa Farac
Partner
for Deloitte Limited *(as trustee for the Deloitte Trading Trust)*

#010

Russell McVeagh

27 April 2017

By email

BEPS - Transfer pricing and PE avoidance
c/- Deputy Commissioner, Policy and Strategy
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WELLINGTON 6140

SUBMISSION: BEPS - TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE - A GOVERNMENT DISCUSSION DOCUMENT

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document "BEPS – Transfer pricing and permanent establishment avoidance" (March 2017) ("**Discussion Document**"). We would be happy to discuss any aspect of the submissions.

1.2 We use the following references:

(a) "**DTA**" means a double tax agreement that New Zealand has entered into;

(b) "**Income Tax Act**" means the Income Tax Act 2007;

(c) "**Multilateral Instrument**" means the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*;

(d) "**PE**" means a permanent establishment; and

(e) "**TAA**" means the Tax Administration Act 1994.

2. PERMANENT ESTABLISHMENT AVOIDANCE (CHAPTER THREE)

Summary of proposal and its rationale

2.1 Chapter 3 of the Discussion Document proposes a new anti-avoidance rule that would apply to certain arrangements entered into by multinational groups having annual turnover exceeding EUR750 million which defeat "the purpose of [a] DTA's PE provisions" (Discussion Document at paragraph 3.21). A similar rule is proposed in respect of third party channel providers. Again, the rule would apply only if (among other criteria) the arrangement "defeats the purpose of the PE provisions" (Discussion Document at paragraph 3.27).

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2.2 The Discussion Document refers to the Multilateral Instrument which contains a widened PE definition to counter the avoidance of PE status. Paragraph 3.15 of the Discussion Document explains why the Government is concerned that the OECD's response will not be sufficient to prevent arrangements being entered into to avoid a multinational having a PE in New Zealand:

> This widened definition should be effective in addressing some of the PE avoidance we see in New Zealand. **However an issue with the widened definition is that it will only be included in a DTA if both parties so elect. Several of New Zealand's trading partners are not expected to elect to include the widened PE definition**, including some countries from which significant investment into New Zealand is made. **Therefore, the Government expects that the OECD's PE amendments will not be sufficient to address the issue of PE avoidance in New Zealand**.
>
> [Emphasis added]

2.3 The Discussion Document therefore proposes (see paragraphs 3.40 to 3.45) that the new PE avoidance rule should override New Zealand's DTAs. This aspect of the proposed PE avoidance rule is said to be justified on the basis that "the proposed rule is an anti-avoidance provision [and] will only apply to an arrangement which defeats the purpose of the DTA's PE provisions".

Submission: PE avoidance rule should not override DTAs

2.4 The definition of PE is an important provision in delineating the source country's taxing rights. It appears (given the variations to the definition seen in New Zealand's DTAs) that the PE definition in any given DTA reflects a negotiated position. In those circumstances, New Zealand should not enact a rule that could in effect unilaterally vary the agreed definition. For New Zealand to do so could do significant harm to the confidence that foreign investors have in the stability of New Zealand's tax policy settings and ability to rely on what New Zealand has agreed in its DTAs.

2.5 For these reasons, we submit that:

(a) the PE avoidance rule should be drafted so it is clear that it applies only to arrangements that defeat the purpose of the PE definition in the particular DTA; and

(b) the PE avoidance rule should not override DTAs. Given the comments at paragraphs 3.40 to 3.44 of the Discussion Document, and the fact that the PE avoidance rule would apply only to arrangements defeating the purpose of the PE definition, there is no justification for the avoidance rule to override a DTA. Rather, the rule should be read alongside the relevant DTA, and in light of the recognition in the OECD Commentary (referred to at paragraph 3.42 of the Discussion Document) that there will generally be no conflict between such anti-avoidance provisions and the DTA.

3. AMENDMENTS TO THE SOURCE RULES (CHAPTER FOUR)

Summary of proposals and rationale

3.1 A new source rule is proposed to confirm that income will have a source in New Zealand if it is attributable to a PE in New Zealand ("**proposed PE source rule**"). A domestic law definition of PE is proposed, so that this rule applies even if the non-resident with the PE is resident in a country with which New Zealand does not have a DTA. It is also proposed that a non-resident's income be deemed to have a source in New Zealand if it would have a New Zealand source under a particular source rule, treating the non-resident's wholly owned group as a single entity ("**anti-avoidance source rule**").

Submission: anti-avoidance source rule should not proceed

3.2 The stated rationale for the anti-avoidance source rule is to prevent non-residents from avoiding having New Zealand sourced income by dividing their activities between group members (paragraph 4.23 of the Discussion Document). This issue will, however, be addressed by the broadening of the PE definition in DTAs as a result of the Multilateral Instrument, the PE avoidance rule, which will apply to all PE definitions, and the new PE source rule and domestic law PE definition.

3.3 The only examples the Discussion Document provides of situations in which the anti-avoidance source rule is necessary are of contract-splitting and fragmentation of activities arrangements. Again, these arrangements would be addressed by the changes to the PE definition in the Multilateral Instrument and/or by the proposed PE source rule and PE avoidance rule. Possibly for this reason, the Discussion Document does not refer to (and we are not aware of) any international precedent for a wide-ranging anti-avoidance source rule such as is proposed.

3.4 In summary, we therefore submit that the proposed anti-avoidance source rule should not proceed. It would introduce unnecessary complexity in light of the proposed PE source rule, other source rules and the broadening of the PE definition in a number of DTAs as a result of the Multilateral Instrument. In addition, it runs the risk of conflicting with DTAs and appears not to be consistent with international practice.

4. STRENGTHENING THE TRANSFER PRICING RULES (CHAPTER FIVE)

Reconstruction power in domestic law is unnecessary

4.1 It is proposed that New Zealand's transfer pricing legislation include an explicit reference to the latest OECD Transfer pricing guidelines. If our domestic law is amended to incorporate the guidelines, we submit that there is no need for an additional reconstruction power in domestic legislation, as such a power is already contained in the guidelines in appropriate cases (see paragraphs 1.64 to 1.69 of the guidelines).

Burden of proof should not be shifted to the taxpayer or, alternatively, procedural protections are necessary

4.2 It is proposed that the burden of proof be placed on the taxpayer rather than the Inland Revenue. The stated reason for the proposed change is that multinational structures and transactions have become more complex since the transfer pricing rules were introduced, and that the taxpayer has better information than Inland Revenue does.

4.3 Under current law, the taxpayer determines the arm's length amount in the first instance, but Inland Revenue may determine the amount where Inland Revenue can demonstrate that another amount is a more reliable measure, or where the taxpayer has not co-operated with Inland Revenue (section GC 13(4) of the Income Tax Act). Therefore, while the underlying transactions may be complex, and while the taxpayer should have access to information supporting its determination of the arm's length amount, the taxpayer must nonetheless justify to Inland Revenue the arm's length rate it has determined and persuade Inland Revenue that another amount (proposed by Inland Revenue) is not a more reliable measure of the arm's length amount.

4.4 The current law recognises that there will usually be a range of arm's length prices rather than one precise arm's length amount. In the context of a self-assessment system, it should be sufficient for the amount determined by the taxpayer to be within the range of arm's length amounts. Section GC 13(4) achieves this, whereas placing the onus on a taxpayer to disprove Inland Revenue's asserted arm's length rate would not.

4.5 In the alternative, if the proposed change to the onus of proof does proceed, Inland Revenue should only be able to rely on publicly available information as the basis for whatever arm's length rate it asserts. This needs to be an express requirement in the legislation. If the taxpayer has the onus of proof in respect of a transfer pricing dispute, they need to have full access to the same information that the Inland Revenue is using. Inland Revenue should not be permitted to rely on tax secrecy to decline to disclose details underlying data that Inland Revenue may be relying on.

The time bar should not be extended

4.6 It is proposed that the time bar for transfer pricing matters be increased to seven years. The policy underlying the time bar and the significant role that it plays in the tax system is well known. In the government 2003 discussion document entitled *Resolving tax disputes: a legislative review* it was stated (at paragraph 6.2) that:

> Time frames provide certainty and finality in respect of a person's tax position. The finality provided by the four-year statutory time bar is emphasised by the courts as central to tax administration so that after the stipulated period of time taxpayers and Inland Revenue may close their books and dispose of their papers.

4.7 The stated rationale for lengthening the time bar in respect of transfer pricing disputes is that such disputes are very dependent on the facts and circumstances of the specific case. This rationale is difficult to sustain. Tax disputes generally are often very dependent on the facts and circumstances. A number of examples are readily available, for example capital/revenue disputes (such as the *Trustpower* case) and tax residency disputes.

4.8 To extend the time bar in transfer pricing matters would provide the wrong incentives for all parties. A particular difficulty in transfer pricing matters is that there will usually be no single "right" answer but instead a range of prices or rates that should be consistent with the arm's length standard. A further difficulty is that the search for comparables could (potentially) be endless if there is not a time limit on the parties to bring the issues to a head.

4.9 In our experience, these factors can result in transfer pricing investigations and disputes (already) taking longer than they should. Time limits are especially important in such cases, to encourage the parties to compromise if they can, and if they cannot compromise, setting a time limit within which an assessment must be made so the case can be considered by the court.

4.10 Finally, we submit that the table at paragraph 5.70 of the Discussion Document comparing the standard time bar and time bar for transfer pricing issues in a number of jurisdictions is not compelling evidence that New Zealand should change its approach. While Australia and Canada have adopted the approach that the Discussion Document proposes, many other jurisdictions, such as the US and the UK, have not done so.

4.11 Accordingly, we submit that the time bar should not be extended.

5. ADMINISTRATIVE MEASURES (CHAPTER SIX)

Any determination that a large multinational is non-cooperative (see paragraphs 6.13 to 6.20 of the Discussion Document) should be subject to additional procedural safeguards

Criteria and process for determining that a taxpayer is non-cooperative need to be clear, transparent and principled

5.1 A determination that a taxpayer is non-cooperative will not only have adverse consequences for the taxpayer under the proposed rules, but could also have significant reputational consequences for the taxpayer. As such, we submit that the definition of non-cooperative should be set out in legislation and further procedural safeguards should be provided for the taxpayer.

Statutory definition

5.2 Any statutory definition should make it clear that a taxpayer is not non-cooperative merely because the taxpayer exercises its right to dispute Inland Revenue's position or to contest any steps that Inland Revenue may take in an investigation. We are concerned that any definition that provides

otherwise would be inconsistent with section 27(3) of the New Zealand Bill of Rights Act 1990. Relevantly, section 27(3) provides that:

> Every person has the right to bring civil proceedings against, and to defend civil proceedings brought by, the Crown, and to have those proceedings heard, according to the law, in the same way as civil proceedings between individuals.

5.3 The White Paper on the Bill of Rights was in the same terms as the current Act. The White Paper commentary noted that the purpose of what is now section 27(3) was:

> to give constitutional status to the core principle recognised in Crown Proceedings Act 1950: that the individual should be able to bring legal proceedings against the Government, and more generally to engage in civil litigation with it, without the Government enjoying any procedural or jurisdictional privileges. This is central to the rule of law.

5.4 The Courts have interpreted the right consistently with the White Paper.[1] If Inland Revenue could deem a taxpayer to be non-cooperative merely because the taxpayer is questioning or resisting (using proper process) some action Inland Revenue is taking in connection with a dispute, this would provide a procedural advantage to Inland Revenue that is not enjoyed by a lay litigant. This would be contrary to the right enshrined in section 27(3).

Further procedural safeguards

5.5 In addition to the statutory definition, Inland Revenue should issue guidance regarding the process to be followed in determining whether a taxpayer is non-cooperative. Such guidance should be in the form of a Standard Practice Statement.

5.6 We agree with the Discussion Document (at paragraph 6.16) that the power to make any such determination should be confined to a relatively small number of officials within Inland Revenue. This should help achieve a consistency of approach. Furthermore, we submit that the senior official making such a determination should be independent from the personnel auditing/investigating or otherwise engaged with the taxpayer.

5.7 We also agree that Inland Revenue should warn the taxpayer before any determination is made. We submit that this should take the form of a written notice specifying the acts or omissions that Inland Revenue considers make the taxpayer non-cooperative. The taxpayer should then have the opportunity to respond to the warning and/or to remedy the acts or omissions that Inland Revenue has specified.

5.8 It is important for a taxpayer to have a right to challenge (before a court) any decision of Inland Revenue to deem it to be non-cooperative. As noted above, any decision to deem a taxpayer to be non-cooperative may have consequences going beyond the proposals in the Discussion Document.

1 See for example *Vinelight Nominees Limited v Commissioner of Inland Revenue* (2005) 22 NZTC 19,298 at [52]–[55].

The proposal to bring forward the date for payment for tax in dispute (paragraphs 6.21 to 6.26 of the Discussion Document) is arbitrary and should not proceed

Primary submission: proposed amendment is unnecessary and should not proceed

5.9 The Discussion Document proposes that the payment of tax in dispute for large multinationals in a dispute with Inland Revenue in relation to certain disputes be brought forward. We submit that this proposal is unjustified for the following reasons:

(a) The proposed rule is arbitrary. The Discussion Document proposes that the rule apply where the dispute relates to transfer pricing, the amount of income with a New Zealand source or the amount of tax payable under a DTA. We submit that there is nothing special about these matters to warrant the payment of tax in advance.

(b) The general rule that disputed tax be payable only following final determination of any dispute should remain. In cases where Inland Revenue considers there to be a significant risk that the tax in dispute will not be paid should the disputant's challenge be unsuccessful, the Inland Revenue can require the taxpayer to pay the tax early (see section 138I(2B) of the TAA).

(c) Contrary to the suggestion in the Discussion Document (at paragraph 6.21) large multinationals are not currently incentivised to delay the resolution of a dispute. The rate of use of money interest is materially higher than commercial rates for large multinationals. While the ability of a taxpayer to access funds in a tax pooling account can mitigate to some extent the use of money interest regime, it does not eliminate it since the use of tax pooling involves its own costs.

(d) The Discussion Document provides no evidence of large multinationals not paying disputed tax found to be owing at the conclusion of the dispute. If there is a risk of non-payment in a particular case, Inland Revenue has the power (in section 138I(2B) of the TAA) to require advance payment, as noted above.

5.10 Further, there is no justification for the Discussion Document proposal to restrict the use of tax pooling in disputes relating to transfer prising, the amount of income with a New Zealand source or the amount of tax payable under a DTA. The tax pooling rules were introduced in order to allow taxpayer to "[reduce] use-of-money interest exposure".[2] The Discussion Document offers no justification as to why that rationale does not apply (and tax pooling should not be available) in the three categories of dispute identified.

2 Inland Revenue Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* (November 2002) at 3.

Alternative submission: If the proposal does proceed, payment should be required within 90 days of Inland Revenue issuing an assessment and there should be further procedural safeguards

5.11 If the proposal does proceed, we submit that the first of the alternative options should be implemented (ie, that payment should be required within 90 days of Inland Revenue issuing an assessment for the tax in dispute). We consider that this would strike a more appropriate balance than the requirement to pay within 12 months of Inland Revenue issuing a notice of proposed adjustment.

The power to collect tax from a wholly owned subsidiary of a large multinational in New Zealand (paragraphs 6.27 and 6.28 of the Discussion Document) is unnecessary and inappropriate

Primary submission: proposed amendment is unnecessary and should not proceed

5.12 The Discussion Document proposes that any tax payable by a member of a large multinational would be collectible from "any wholly owned subsidiary of the multinational in New Zealand" and from "the related New Zealand entity in a case where the income is attributed to a deemed PE of the non-resident under the proposed PE avoidance rule" (discussed above).

5.13 The proposed rule will have the effect of making all wholly owned group members of a large multinational group jointly and severally liable for the tax obligations of the other members of the group. This overrides the fundamental principle of separate legal personality for companies and limited liability for obligations of a company.

5.14 We are unaware of any existing difficulty resulting from members of a large multinational group not paying tax which is due and payable which would justify this proposed new rule. The Discussion Document does not provide (or even suggest that there is) any evidence of such difficulties arising.

5.15 Under the *Convention on Mutual Administrative Assistance in Tax Matters*, Inland Revenue has the power (see Articles 11 to 16) to request assistance from other jurisdictions in the collection of tax owing. New Zealand should maintain its commitment to international cooperation in BEPS matters by using that convention, rather than seeking to impose unilateral measures which cut across fundamental principles of corporate law.

Alternative submission: If the proposal does proceed, further taxpayer protections should be implemented

5.16 If the proposal does proceed, we submit that Inland Revenue should be required to obtain a court order to collect tax from an entity other than the entity against which the tax was assessed. As noted above, the proposed rule is a significant departure from the norms of corporate law and any exercise of such a power should be subject to judicial supervision.

Russell McVeagh

Collection of information from offshore group members (paragraphs 6.29 to 6.37 of the Discussion Document)

Overview

5.17 The Discussion Document proposes to make a New Zealand entity responsible for providing information that Inland Revenue believes is held by another member of the large multinational group. The proposal would go further than the current powers in section 17 of the TAA which requires a person to provide information held by foreign entities which that person controls.

5.18 The Discussion Document at paragraph 6.35 proposes a "consequential change" to section 143(2) of the TAA to allow a person to be convicted of an offence if the person does not provide information alleged to be held by a non-resident associated person. The proposal means that a New Zealand group member could be convicted of an offence in respect of acts or omissions by one or more non-resident associates even though the New Zealand group member may have no control or influence over that associate.

The proposed rule has been rejected previously

5.19 An amendment to section 17 of the TAA that would have required a New Zealand person to furnish information held by non-resident associated persons was proposed in the *Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill* as introduced.[3] Following submissions to the Select Committee, it was accepted that the application of the rule should be restricted.[4] This narrowed rule (applying only to information held by foreign entities controlled by the New Zealand person, not to all non-resident associates of the New Zealand person) was subsequently enacted.

Reference to Australian and Canadian provisions

5.20 Paragraph 6.34 of the Discussion Document states that the proposed change:

> … would align New Zealand's offshore information powers with other countries' such as Australia and Canada which have specific provisions that enable their tax authorities to directly request information or documents from offshore
>
> [Footnotes omitted]

For the reasons given below, the Australian and Canadian provisions are materially different from what is proposed in the Discussion Document.

3 Clause 75.

4 Inland Revenue *Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* ((November 2002) at 110.

Australia

5.21 The Discussion Document refers to section 264A of the Income Tax Assessment Act 1936 (Cth). Unlike the general power to request information in section 17 of the TAA, section 264A of the Income Tax Assessment Act 1936 (Cth) is directed at the particular risk to the Australian Commissioner of offshore information not being provided during an investigation and subsequently being used in proceedings to dispute an assessment.[5]

5.22 Failure to comply with an information request is not an offence.[6] The only sanction for failure to comply with a notice under section 264A is evidentiary (ie, the information that the taxpayer failed to provide under the notice cannot be used in subsequent proceedings to dispute an assessment).[7] In addition, there is greater scope to challenge the Australian Commissioner's decision to issue a notice given the more circumscribed nature of the power.[8]

Canada

5.23 The Canadian provision in section 231.6 of the Income Tax Act RSC 1985 c 1 also provides more scope for a taxpayer to challenge a decision to request information. Section 231.6(5) sets out the powers of a Judge when reviewing the decision to issue a request for foreign-based information or documentation. A Judge, on application of the taxpayer, may:

> (a) confirm the requirement;
>
> (b) vary the requirement as the judge considers appropriate in the circumstances; or
>
> (c) set aside the requirement if the judge is satisfied that the requirement is unreasonable.

5.24 Case law has clarified that a notice must be reasonable in all circumstances. That the information is held by a non-resident who is not controlled by a taxpayer will not make the request unreasonable,[9] however, the fact that the information is held by a non-resident who is controlled by the taxpayer will not make it reasonable.[10] A balancing exercise must be undertaken by the Judge in each case.

5.25 The consequence of failing to comply with a notice is similar to the Australian provision. Section 231.6(8) provides that:

> If a person fails to comply substantially with a notice served under this subsection 231.6(2) and if the notice is not set aside by a judge pursuant to section 231.6(5), any court having

5 *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia* [1994] FCA 1492; (1994) 54 FCR 75 at [30].

6 Income Tax Assessment Act 1936 (Cth), section 264A(22)

7 Michael Chow (ed) *Australian Master Tax Guide* (56th ed, CCH Australia Limited, Sydney, 2015) at [21-220].

8 *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia*, above n 5, at [34].

9 Income Tax Act RS C 1985 c 1, s 231.6(6).

10 See *Fidelity Investment Canada Ltd v Canada (Revenue Agency)* 2006 FC 551 at [32]; and *Soft-Moc Inc v Canada (National Revenue)* 2013 FC 291 at [32].

> jurisdiction in a civil proceeding relating to the administration or enforcement of this Act shall, on motion of the Minister, prohibit the introduction by that person of any foreign-based information or document covered by that notice.

5.26 In addition, a penalty can be imposed under section 238(1) but only by the court. On summary conviction, a taxpayer is liable to a fine of no more than CAN$25,000 and/or up to 12 months imprisonment.

Discussion Document's justification for the proposal

5.27 The Discussion Document notes that Inland Revenue can and does request information from foreign tax authorities using its exchange of information rights. The Discussion Document suggests however, that these powers are inadequate for two reasons:

> Recent improvements to the exchange of information between tax authorities are making it easier for Inland Revenue to request and exchange information that is held by offshore tax authorities. However, relying on an ability to request information indirectly from other tax authorities is not always adequate. In some cases, the relevant information is not held by the offshore tax authority and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.

5.28 The first reason given is that the relevant information is in some cases "not held by the offshore tax authority". But this is not a compelling argument, since foreign tax authorities can and do exercise their own information gathering powers to obtain information that Inland Revenue requests under the DTA, just as Inland Revenue does when it receives requests for information from foreign revenue authorities.

5.29 It is difficult to evaluate the second aspect of the justification (that the foreign tax authority may be slow or unhelpful in responding) without knowing how common this is. It is to be hoped that this is not often the case given that the DTA or Tax Information Exchange Agreement ("**TIEA**") (as applicable) imposes an obligation on the foreign Government to comply with a valid request, and that New Zealand (presumably) complies with its obligations under the DTA or TIEA.

5.30 But to the extent Inland Revenue might sometimes encounter difficulties or delays in obtaining information from a foreign revenue authority, we note that the New Zealand resident companies may be in no better position to compel a non-resident group member to supply information. This has been recognised by the courts in the discovery context. In that context, the courts are unlikely to order discovery when the information is held by an entity which the relevant party has no control over.[11] For the New Zealand company, it is not simply a matter of requesting the information from (or forwarding on Inland Revenue's information request to) the relevant foreign affiliates and expecting that the

11 See for example *Howard Trading Auckland Limited and Anor v Nissan New Zealand Limited* HC Auckland CIV-2009-404-003111 at [32].

information will be provided. There are more obvious practical difficulties which, we submit, makes this proposal unworkable:

(a) Multinational groups may be comprised of a large number of companies in many countries. It may be impossible for personnel working for the New Zealand entity to know which company holds what information.

(b) Inland Revenue information requests are often very broadly worded, and may call for the production of large numbers (not infrequently thousands) of emails and other documents, which in turn could necessitate the review of an even greater number of documents to determine which are within the scope of the request. For such requests to apply not only to the New Zealand group but also to foreign associated persons could make the requests so costly and burdensome to comply with that compliance is for all practical purposes impossible.

(c) The New Zealand company will usually have no legal right to require a foreign associate to provide information to it. And even if the foreign associate is willing (in the interests of the group) to devote the time and resources necessary to assist the New Zealand company in locating and providing relevant documents, the foreign associate will need to consider whether it is appropriate to do so. For example, some of the information may be legally privileged. And local privacy and confidentiality laws will need to be considered.[12]

Alternative submission: if the proposal does proceed a court order should be required

5.31 If the proposal does proceed, Inland Revenue should be required to obtain a court order to require the New Zealand entity to provide information not held by it or by an entity it controls. This would provide judicial oversight in respect of the breadth of the request and feasibility of complying with it, and as to whether the need for such an onerous power to be exercised is justified in the circumstances and its exercise would be reasonable.

5.32 We further submit that Inland Revenue should not have the power to impose a penalty for non-compliance with the offshore information request. New Zealand should follow the Australian and Canadian approach. Failure to comply with the information request should only result in evidentiary consequences unless a court imposes a penalty.

12 These considerations were behind the need for FATCA to be implemented through Intergovernmental Agreements, such as that concluded between New Zealand and the United States. Had New Zealand financial institutions agreed to provide information directly to the United States (pursuant to an agreement with the United States Government under section 1471 of the Internal Revenue Code) they may have been in breach of their implied contractual obligation of confidentiality and/or their obligations under the Privacy Act 1993. For them to disclose the information to another Government to avoid a financial detriment (FATCA withholding) may not have been recognised as falling within the disclosure under compulsion of law exceptions to their confidentiality and Privacy Act obligations.

Penalties for not providing information requested by Inland Revenue

Penalty for non-compliance should be required to be imposed by the court

5.33 The Discussion Document proposes that a civil penalty of $100,000 can be imposed by Inland Revenue if a large multinational fails to comply with an information request under section 17 or section 21. We submit that any power to impose such a penalty should rest with the Courts and not with Inland Revenue.

Alternative submission: if the proposed rule is introduced, taxpayers should have the right to apply to the court for relief

5.34 We submit that if the proposed rule is introduced, taxpayers should have the right to apply to the Court to have the penalty reduced or set aside. This is a necessary minimum requirement to comply with section 27 of the New Zealand Bill of Rights Act 1990 and should be explicit in the legislation.

General comments on section 21 of the TAA

5.35 Section 21 of the TAA should be rewritten or repealed. Inland Revenue has comprehensive information gathering powers under section 17 of the TAA. Section 21 is arbitrary in its application (being triggered by the non-response to an information request after 90 days, without regard to whether that time-frame is reasonable in the circumstances) and draconian in its consequences (denying a taxpayer access to the courts to challenge an assessment).

5.36 We do not consider there to be any reason why section 17 and section 21 should vary in their application. Denying a taxpayer access to the courts is, as discussed above, on the face of it a breach of section 27(3) of the New Zealand Bill of Rights Act. Section 21 therefore requires (at a minimum) to be reviewed, and unless on review it can be established that section 21 fulfils a purpose that is not met by section 17 then section 21 should be repealed.

Yours faithfully
RUSSELL McVEAGH

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26 July 2017

BEPS – Transfer pricing and PE avoidance C/-
Deputy Commissioner, Policy and Strategy Inland
Revenue Department PO Box 2198 Wellington 6140

Via email: policy.webmaster@ird.govt.nz

Submission re: BEPS - Transfer Pricing and Permanent Establishment Avoidance Discussion Document

Dear Deputy Commissioner, Policy and Strategy:

On behalf of the National Foreign Trade Council (the "NFTC"), we appreciate this opportunity to submit comments with respect to the "BEPS -Transfer pricing and permanent establishment avoidance" discussion document (the discussion document).

The NFTC, organized in 1914, is an association of approximately 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial and service activities and the NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment and through direct investment in facilities abroad. Foreign trade is fundamental to the economic growth of U.S. companies

The NFTC appreciates the willingness of the New Zealand Department of Inland Revenue (Inland Revenue) to request and consider comments regarding the discussion document. Contrary to the assertion made in paragraph 1.4 that "[t]hey are not intended to make any fundamental changes to the current international tax framework', the NFTC believes the discussion document diverts from international norms and the OECD Base Erosion & Profit Shifting (BEPS) Action Plan in which New Zealand agreed and actively participated. The NFTC agrees with the statement in paragraph 1.5 that "It is important to enforce the

integrity and efficiency of the tax system in designing tax policy so that there is a level playing field." However, while seemingly justifying the proposals in the discussion document by reference to Australian and UK efforts, enactment of the unilateral actions in the discussion document will make New Zealand an outlier, increase tax uncertainty, negatively affect foreign direct investment into New Zealand, and may lead to other countries enacting unilateral actions that erode progress made in the BEPS Action Plan.

A summary of the NFTC's major points and recommendations are as follows:

Source and permanent establishment avoidance

1 The NFTC believes the proposed PE Anti-Avoidance Rule "deeming" a non-resident entity to have a permanent establishment in New Zealand if a related entity carries out sales activity in New Zealand will apply to non-abusive common regional sales structures with New Zealand sales and support entities that are appropriately compensated. This subjective proposal ignores legal entities, is outside of the OECD BEPS Action Plan, will apply to common non-abusive regional sales structures, and creates significant uncertainty and unnecessary disputes with taxpayers and between New Zealand and its trading partners.

2 If Inland Revenue believes these local sales support activities are not appropriately compensated, the NFTC believes the analysis should be considered under the transfer pricing guidelines rather than subjectively "deeming" a permanent establishment which may or may not have any additional profit attributable to the PE.

3 The reference in paragraph 3.24 regarding "[w]hether the arrangement has any of the indicators of PE avoidance, such as the involvement of a low tax jurisdiction, specialized services, or a related entity which is allocated a low amount of profit on the basis it is carrying out low value activities while having a number of well paid employees", illustrates that any concerns should be considered using a transfer pricing analysis rather than creating a 'deemed" PE. Contrary to the statement made in paragraph 3.26 that "[i]t is not intended to deem a PE to exist where one does not in substance", the discussion document does just that.

4 The helpful examples in the Appendix actually support the case that any New Zealand concerns should be addressed via a transfer pricing analysis rather than "deeming" a PE.

5 In example 1, a direct sale by a non-resident from offshore does not create New Zealand source income or a deemed New Zealand permanent establishment. As mentioned, "[f]rom a policy perspective this outcome is entirely in accordance with the current norms of international taxation which New Zealand – as well as other countries – follow." The NFTC agrees.

6 However, in Example 3, a direct sale from offshore with in-market sales activities would, as a result of the discussion document "ensure that the New Zealand subsidiary's sales activity created a PE for the non-resident; deem the non-resident to supply its goods or services through the PE; ensure the non-resident's sales income had New Zealand

source; and allow New Zealand to apply NRWT to the royalty paid by the non-resident to the related entity resident in the no tax jurisdiction under any applicable DTA." The discussion document notes: "[u]nder the in-market support structure, the New Zealand subsidiary is paid a fee for its services, but this fee generally only exceeds its costs by a small margin." The NFTC submits that this is a transfer pricing issue rather than a permanent establishment issue. As a matter of policy, ignoring legal structures and "deeming" a PE for customary and non-abusive in-market sales activity, will create substantial uncertainty and may result in the non-resident eliminating local sales support functions to minimize PE risk to the detriment of the New Zealand economy and consumers

7 In addition, the NFTC believes that applying the subjective rule in the discussion document to "deem" a permanent establishment "under an arrangement in which those goods or services are to be on-sold to customers in New Zealand by a third party (whether related or not)", will create additional uncertainty and PE risk that may negatively affect a non-resident's decision to participate in the New Zealand market. The NFTC is concerned about the unpredictability and uncertainty caused by enacting domestic legislation which overrides the OECD PE standard. In this regard, the statement in 3.45 that the "PE avoidance rule would apply notwithstanding anything in the DTA" seems contradictory to the statement in 3.2 that "the proposed rule is not intended to widen the accepted international definition of PE in substance". There is also an explanation in Section 3.15 that the domestic rule is being considered to address situations where a DTA does not exist or where the "broadened" language is not accepted in the DTA. The PE standard being considered for adoption is admittedly broader than the OECD definition.

8 The term "third party" buyer in the factors listed in 3.27 should be defined consistently with the description in 3.31 which carves out of the rule entities which purchase goods from a non-resident and independently sell them to third parties. In 3.27, the third bullet should clarify that "carrying out an activity related to the sale" does not apply when the buyer is independently selling to third parties. Otherwise the language in 3.27 is ambiguous. The definition of an independent third party should exclude third parties who are not managed or controlled by the offshore seller or are publically traded.. In these instances, it is not possible to offer sales of supplies on other than arms-length terms.

9 In the bullet point 3.24 where the application of the rule is discussed, the specific bullet addressing the nature of the services carried out should indicate that the rule would potentially apply only where the services include locating customers, promoting products to those customers, discussing the customer's needs and tailoring the product to be sold for the customer, and indicating pricing and delivery dates and other key terms to the customer", to be consistent with the example in 3.26.

10 Regarding the interaction with New Zealand's double tax agreements, paragraph 3.45 provides "' [w]e propose providing that our PE avoidance rule would apply notwithstanding anything in a DTA." The NFTC believes such unilateral action will

further erode the tax treaty network, erode international tax norms, and result in more tax disputes between New Zealand, taxpayers, and New Zealand's international trading partners.

Chapter 5: Strengthening the transfer pricing rules

11 Paragraph 5.69 notes that "[I]t can be difficult for tax authorities to adequately identify the risk, apply the arm's length principle and amend the relevant tax return within four years." Citing Australia and Canada as precedent for a seven-year time bar for transfer pricing, the discussion document proposes increasing New Zealand's time bar for transfer pricing matters to seven years.

12 The NFTC believes the difficulties identified in the discussion document should be adequately addressed by the Government's proposal to shift the burden of proof from the Commissioner to the taxpayer in transfer pricing matters. Extending the time bar to seven years in transfer pricing cases will increase uncertainty, delay timely resolution, and add to the inventory, time, and administrative costs for New Zealand and its treaty partners. A reasonable time bar benefits both taxpayers and tax administrators by not overly prolonging a transfer pricing determination. As such, the extension of the time bar should not proceed.

13 If the time bar extension does proceed, consideration needs to be given to the interaction of the extended time bar for transfer pricing matters, the impact on competent authority cases, and the time bar applicable for other purposes. An adjustment for transfer pricing could also have an impact on withholding tax and income tax. The NFTC is concerned that extending the time bar for transfer pricing matters may result in unintended consequences including a de facto extension of the time bar for other tax types, an inability for taxpayers to claim offsetting adjustments when transfer pricing matters are reassessed, and a growing inventory of expensive and prolonged competent authority cases for New Zealand and other governments.

Chapter 6: Administrative measures

Non-cooperation

14 Chapter 6 proposes to introduce new administrative measures that would apply to large multinationals as a result of non-cooperation. The proposed measures include the ability for Inland Revenue to issue an assessment based on information held at the time; and impose penalties for failure to comply with information requests.

15 The discussion document states in paragraph 6.17 that the proposed rules are not intended to impose unreasonable demands on multinationals. However, some of the factors put forward in the proposal in paragraph 6.16 are sufficiently vague and subjective including:

- Failure by the taxpayer to provide information within the possession or control of the taxpayer ***or its associated parties*** [emphasis added] within a statutory timeframe;

- Failure to respond to IR correspondence; the provision of misleading information (including where the information is misleading by omission);

- Failure to provide sufficient information to determine the arm's length amount of a related party transaction, or to determine the amount of profit which should be attributable to a PE;

16 The NFTC believes the threshold at which a large multinational is treated as "non-cooperative" should be carefully considered by Inland Revenue which should consider the following when determining that a taxpayer is "non-cooperative":

- Information requests by Inland Revenue can be onerous and sourcing the level of material can often be difficult to obtain from within large organisations within timeframes set by Inland Revenue. The NFTC notes that delays in obtaining relevant information are generally not driven by unwillingness of taxpayers to provide information, but are a product of practical difficulties of sourcing relevant information from within large organisations. Practical difficulties faced by large multinationals are similar (and probably more significant in comparison) to difficulties experienced by large New Zealand corporations. NFTC does not consider it appropriate or necessary to require a different standard of co-operation for large multinationals in comparison to large New Zealand corporate taxpayers.

- Taxpayers that are required to provide a significant amount of information often treat the process of obtaining and providing information to Revenue Authorities as if it was part of the process of legal discovery to avoid costs involved in repeating the process if the matter progresses to litigation. This inevitably involves a more thorough process of data capture, compilation and review, with associated additional time and cost involved.

Payment of tax in dispute

17 The NFTC is concerned that payment of tax in disputes in advance of resolution may lead to inappropriate assessments, inappropriate incentives for Inland Revenue officials, and a substantial increase in tax risk and uncertainty which could chill foreign direct investment into New Zealand. Contrary to the assertion in paragraph 6.26 that the rule to impose early payment is intended to remove any incentive to prolong a dispute with Inland Revenue, the NFTC asserts that taxpayers favor early resolution of disputes. In any event, imposing interest on a final assessment, if any, fully compensates the government for the time before a final assessment is ascertained.

Collection of information

18 Paragraph 6.33 of the discussion document proposes that the Commissioner be provided with a direct power to request information or documents that are held by or accessible to a group member that is located outside New Zealand. The discussion document recognises that there have been recent improvements to the exchange of information between Revenue Authorities, making it easier for IR to obtain information. However, the discussion document states that in some cases the relevant information is not held by the offshore tax authorities and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.

19 The NFTC notes that in addition to automatic exchange of information with other Revenue Authorities, the ability of Revenue Authorities to collect information from large multinationals has also increased as a result of the OECD country-by-country reporting initiative.

20 The NFTC believes that the proposal to introduce specific provisions to enable Inland Revenue to directly request information or documents from a group member that is located outside of New Zealand is unlikely to result in Inland Revenue receiving information in a timelier manner than it would if it were to request the same information from the New Zealand taxpayer under New Zealand's existing rules. Delays in responding to appropriate and relevant information requests from Inland Revenue are attributable to practical difficulties of sourcing appropriate and relevant information within large organisations, rather than because of unwillingness by large multinationals to provide relevant information.

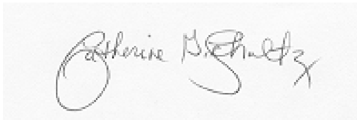
Penalties for not providing information

21 Paragraph 6.35 of the discussion document proposes that a person may be convicted of an offence for failing to provide information held by an associated offshore group member.

22 The NFTC believes it would be inappropriate for New Zealand to expect officers and/or directors of the relevant New Zealand subsidiary to have access to offshore information, the ability to require offshore parent companies to provide information, or the ability to influence the production of non-New Zealand information appropriately or inappropriately requested by Inland Revenue. Exposing local officers and or directors to substantial penalties for failure to produce documents outside of their control is inappropriate and would materially impact the willingness of individuals to act as officers of New Zealand subsidiaries of multinational groups. The NFTC believes that it would not be reasonable or appropriate to impose penalties on New Zealand officers and/or directors for failing to provide information held by an associated offshore group member outside of their control.

The NFTC appreciates Inland Revenue's willingness to consider our comments and concerns. If you have any questions or comments regarding our submission, please feel free to contact me at 202 – 887-0278.

Sincerely,



Catherine G. Schultz

Vice President for Tax Policy

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28 April 2017

Interest limitation #023
TP +PE #012

BEPS – Transfer pricing, PE avoidance & Interest limitation rules
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

By email: policy.webmaster@ird.govt.nz

Dear Cath

BEPS – Transfer pricing, PE avoidance and proposed interest limitation rules

The American Chamber of Commerce in New Zealand Inc appreciates the opportunity to comment on New Zealand's proposals for international tax reform released on 3 March 2017.

The American Chamber of Commerce in New Zealand Inc – better known as AmCham – has been New Zealand's number one business organisation for the promotion of trade and investment between the United States and New Zealand and the Asia Pacific region for over 50 years. We are "The Voice of American Business in New Zealand". Our members represent turnover in excess of NZ$50 billion and over 100,000 employees.

Our submission covers two Government discussion documents – BEPS – Transfer pricing and permanent establishment avoidance and BEPS – Strengthening our interest limitation rules.

We provide comments on the overall approach which we recommend should be adopted by the Government, supplemented by our recommendations for changes to the specific proposals regarding permanent establishments ("PEs"), interest limitation rules and transfer pricing.

1. Executive Summary

Inbound investment from the United States is important to New Zealand – both in absolute dollars (at least 8% of total foreign direct investment ["FDI"]) and through wider contributions to the economy and society. Tax policy should recognise the importance of inbound FDI while ensuring that inbound investors, including our members, pay their "fair share".

Fairness and certainty considerations lead us to supporting implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem. However, there is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

With regards to the proposals concerning PE avoidance:

- *We support enforcement of the accepted international definition of a PE. This is best done by way of implementing the Multilateral convention to implement tax treaty related measures to prevent BEPS rather than a unilateral PE anti-avoidance rule.*

- *Should New Zealand proceed with the PE anti-avoidance rule, clarity of scope and application is essential, there should be a transitional rule to allow our members the time to restructure and guidance from Inland Revenue regarding profit attribution would be welcome.*

We agree with aspects of the proposed reforms to interest limitation rules but wonder if the Government has lost sight of the strength of New Zealand's existing thin capitalisation rules. Members have major concerns regarding the proposed limit on interest rates on related party loans, as it will lead to double taxation in many cases and is incompatible with the arm's length principle.

We agree in principle with the change to require total assets to be calculated net of non-debt liabilities, but our members should be given time to adjust their existing arrangements. Other conditions for our support include that the ability to use net current asset values is retained, deferred tax liabilities are excluded from the definition of non-debt liabilities and existing financing arrangements are grandparented for an extended period.

With respect to transfer pricing, we support aligning New Zealand's transfer pricing rules to OECD Guidelines. Better alignment with the Australian transfer pricing rules is also appropriate, but only to the extent that those rules remain consistent with the principles set down by the OECD and do not seek to target a greater than arm's length proportion of profit.

Members do have concerns regarding the references to limited risk distribution ("LRD") structures. LRD structures commonly reflect commercial substance and are frequently embedded within a global group's worldwide framework. The LRD structure is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken is often relatively low in terms of value-add.

Members also see a number of the administrative measures proposed as inappropriate. We have concerns regarding penalties for not providing information, the factors leading to a finding that a taxpayer is non-cooperative, Inland Revenue's additional information gathering powers and the enforced early payment of tax in dispute.

We expand on these issues below.

2. Importance of New Zealand/United States relationship

The United States is New Zealand's second largest source of foreign direct investment, representing at least 8% of total FDI.

Many American inbound investors create substantial value through their business activity here, over and above the tax paid, in ways not visible through financial statements alone.

Tax policy should take account of these hard to measure spillover effects while ensuring that inbound investors continue to pay their fair share.

As the world has become more interconnected FDI has increasingly become a hot topic. For New Zealand how we connect with the world is a major issue since we import most of our technology and have a relatively shallow domestic capital base.

New Zealand–United States trade and investment has a considerable impact on the New Zealand economy. The Government has acknowledged our tax settings must "be consistent with maintaining New Zealand's position as an attractive location to base a business." There is a broad consensus that taxation is a significant factor in location decisions regarding inbound investment.

United States companies operating in New Zealand account for investment totalling in excess of NZD 12.6 billion and thousands of jobs. Direct investment in New Zealand is mostly in the finance/insurance and manufacturing sectors, with many investments having some degree of mobility. The United States accounts for at least 8.0% of foreign direct investment into New Zealand. This figure is likely to be materially understated as it excludes investment ultimately sourced from the United States but routed via third countries such as Australia and Singapore. Inland Revenue's own statistics show that, of the 314 foreign owned groups completing its international tax questionnaire, some 59 (or 19%) have ultimate American ownership.

The United States has become New Zealand's third largest trading partner, with trade totalling in excess of NZD 11 billion. In particular, New Zealand's largest imports of tangible goods from the United States include aircraft, jets, motor vehicles, medical instruments, food and appliances.

Our members' businesses have a positive impact on New Zealand society in many ways. Technology companies among our membership are commonly singled out during tax debates due to their digital nature. Yet these members belong to a sector having a transformative effect on the New Zealand economy, with the benefits from their presence extending well beyond New Zealand's receipt of corporate income tax.

Traditional economic and accounting indicators can underplay this effect and lead to the importance of inbound investment being underplayed. The digital economy in particular has the potential to drive future economic growth and productivity when it is adopted by businesses and consumed by users, whereas a large portion of the value of the digital economy goes unmeasured in today's economic indicators. For example:

- *In terms of economic development, the digital economy can help alleviate the "double tyranny" of New Zealand's relative size and distance that affects businesses;*

- *Consumer benefits of digital communication are seen in increased convenience, better access to information, well informed decisions and more time saved in our daily lives; and*

- *With respect to transport, better mapping technology enables improved navigation and helps people find local businesses and tourist destinations.*

AmCham consider that it is legitimate for the Government to take into account the wider spillover effects of our members' inbound investment when setting tax policy. We emphasise that we are not seeking any form of tax break or incentive: it is important that taxes are fair and seen to be fair. Our members are happy to pay their "fair share" in accordance with legislation.

3. Overall comments on the approach taken in the discussion documents

AmCham supports implementation of the BEPS recommendations in New Zealand where such implementation responds to an observable problem.

Our members do not accept that aggressive tax practices are commonplace in New Zealand.

There is a strong case for targeting measures to issues of concern to Inland Revenue rather than imposing compliance costs on members with a good compliance and tax paying history.

Today's business structures have evolved within a dated tax system and everyone will benefit from a simpler, more transparent, tax system.

The members of AmCham support the work of the Organisation for Economic Co-operation and Development ("OECD") and the G20 towards coordinated tax reform to ensure that global tax rules keep pace with business evolution. We recognise that consistent and fair taxation of multinationals has become more difficult in recent years. We also note the Government's consistent support for, and major policy contribution to, the OECD's work.

AmCham therefore agrees a proportionate implementation of the OECD recommendations is the right tax policy for New Zealand.

Keeping the Government's response proportionate to the size of the problem, while not deterring inbound investment, will be crucial. To this end, we agree with the Government that the majority of multinational companies operating in New Zealand comply with their tax obligations and with the

Minister of Revenue that "most foreign-owned firms operating here have relatively conservative debt positions and pay significant amounts of tax." We note further recent research conducted by EY which supports the conclusion that the majority of multinationals are not loading their New Zealand subsidiaries with excessive interest-bearing debt and that the majority have an effective tax rate close to, or equal to, the New Zealand corporate tax rate. While the evidence is not fully conclusive, AmCham does not accept that aggressive tax practices are prevalent in New Zealand.

We are further concerned that measures enacted unilaterally in New Zealand will over time have a similar impact on our New Zealand members operating in overseas jurisdictions. Should all countries implement the full package of measures proposed in New Zealand, such as the interest rate cap or anti-avoidance source rule, double taxation appears inevitable.

AmCham therefore considers it essential for New Zealand to take a measured approach and to stay within international norms. Governments should harmonise tax rules so that businesses can continue to create value. Fragmentation along country lines puts this value at risk. Unilateral action by New Zealand in addressing perceived base erosion and profit shifting ("BEPS") will be harmful if it also creates double taxation. A coordinated approach to BEPS will lead to more certainty for businesses, more efficient economic outcomes and growth, fewer cross-border tax disputes between revenue authorities and a higher global tax-take.

AmCham also endorses New Zealand's international tax framework. We consider the Government needs to confirm that it is open for business, consistent with New Zealand's taxation framework for inbound investment. Foreign businesses will respond favourably to certain and predictable tax laws in New Zealand. The benefits of foreign direct investment are endorsed in the discussion documents.

We note that the package is a powerful combination. It has gained international attention, and will put New Zealand at the forefront of BEPS implementation worldwide.

Given the substantial impact that some components of the package will have, we suggest that the Government consider whether any measures can be targeted at highly geared companies which have sought aggressively to minimise their New Zealand tax liability.

Finally, we support the consultative process adopted by the New Zealand Government.

4. Permanent establishment avoidance

Support for rule which enforces the accepted international definition of a permanent establishment

We agree that economic activities which should result in a PE in New Zealand should be subject to tax here. We therefore support a rule which enforces but does not widen the accepted international definition of a PE in substance.

We further agree that there is no need for a separate diverted profits tax. That said, the proposed PE anti-avoidance rule does replicate elements of the United Kingdom diverted profits tax, notably sharing many features with Australia's multinational anti-avoidance law.

We highlight, however, that New Zealand's implementation of the Multilateral convention to implement tax treaty related measures to prevent BEPS has the potential to address most, if not all, of the attempts to flout PE rules. That approach, being the coordinated international response, is the appropriate mechanism by which to enforce New Zealand's PE rules.

The introduction of more robust transfer pricing rules as proposed in the discussion document will also counteract the need for a specific PE avoidance rule. In particular, the discussion document indicates that the existence of a "number of well paid employees" would be an indicator of the existence of a PE. This could be addressed through the transfer pricing regime, and strengthened transfer pricing rules will assist Inland Revenue in relation to enforcement.

We are concerned that implementation of a unilateral response such as the new PE avoidance rule will impede the coordinated global response to BEPS. We therefore do not support its introduction at this time.

Uncertainty will not lead to good tax administration

There is a risk that vague and uncertain wording within the legislation could lead to disputes about the nature of activities being performed by taxpayers in New Zealand. In particular, a number of phrases and concepts central to the operation of the rule ought to be defined, including "commercially dependent", "in connection with", "low tax jurisdiction", "high paid employee" and "specialised services".

As an example of uncertainty, consider the proposal that an "arrangement involving third party channel providers" should necessarily result in a PE. Any such investigation would be a fact-specific enquiry and would depend on the activities provided by related party and third party channel providers. It will not always be clear whether the related party is performing "sales promotion and services", and there will inevitably be cases where the activities in New Zealand are in reality something less than this, or where the non-resident and the third party are in fact not working together to sell the goods or services to the end customer. The legislation, or guidance supporting the legislation, should be clear as to what kinds of specific arrangements give rise to a deemed PE.

If PE anti-avoidance rules are uncertain or difficult to apply, then the corresponding compliance costs could potentially outweigh the gains to the Government from more tax being paid here. Uncertainty in the rules could dissuade investment into New Zealand. Further, we highlight Inland Revenue's expectations regarding initiatives to tackle complex technical issues (such as PE anti-avoidance). The Commissioner of Inland Revenue is required to collect over time the highest net revenue practicable within the law having regard to the compliance costs incurred by taxpayers. Inland Revenue's

unaudited target return on income for additional funding voted by the Government in 2015/16 was $13.00 per dollar spent, on the basis of the economic inefficiencies involved in chasing down the last dollar of revenue. There is risk that attempted enforcement of the PE anti-avoidance rule will fall short of Inland Revenue's targets.

An ambiguous rule, combined with the proposed 100% penalty, could dissuade investment in a legitimate PE structure, within New Zealand's double tax agreements, on the mere potential that New Zealand would take unilateral action. This would not benefit tax enforcement, the New Zealand economy or our members.

We submit that taxpayers should be able to obtain confirmation from Inland Revenue that the PE avoidance rule would not apply in respect of a particular business structure. The process should operate similarly to an Advance Pricing Agreement ("APA") for transfer pricing purposes, and would add clarity for business with unique circumstances that risk breaching the proposed rule.

Changes to group structure will take time

Reorganising a global supply chain can be a complex business taking a substantial amount of time. New Zealand will often be a small component of a much larger supply chain. The effect of reorganising a global supply chain in a short period of time would be exacerbated for our multinational members operating in a larger number of countries.

We are also concerned that the proposed PE anti-avoidance rule could apply to members whose existing investment structures have previously been reviewed by Inland Revenue by way of a ruling, tax audit sign-off or an APA.

Further, the proposed 100% penalty applicable would present a punitive outcome for such taxpayers with a history of complying with New Zealand tax law if it is not possible for a multinational to reorganise its supply chain before the PE avoidance rule is implemented.

Additional guidance required on profit attribution

We anticipate that multinationals will engage more frequently in disputes with revenue authorities regarding the attribution of profits across jurisdictions.

It is important that the New Zealand Government consider the risk of double taxation where its preferred method of profit attribution differs from that applied in the jurisdiction of the foreign entity.

In light of these substantial proposed changes to the rules around PEs, it would be timely for Inland Revenue to provide additional guidance around the attribution of profit to a New Zealand PE.

5. Interest limitation rules

No case for interest rate cap

Limiting interest deductions based on credit rating within wider group is uncommercial, a departure from the arm's length principle and is likely to lead to cross-border disputes and double tax.

Our members find that there are many circumstances in which a foreign investor might want to invest in New Zealand through debt funding which should appropriately be priced at an interest rate higher than its group cost of funds. The New Zealand entity might be a high credit risk, for example a start-up or different industry. New Zealand is also a small, isolated, market and presents more risk to a (say) United States investor for which the next best alternative would be to expand its existing operations in the United States.

In such circumstances, a third party bank would conceivably lend to the New Zealand subsidiary at an interest rate much higher than the parent company's cost of funds. It will therefore often be more cost-effective for the parent company to provide funding directly to New Zealand. We anticipate that for our members providing finance into New Zealand, double taxation is a likely outcome. The lender will be required by its home tax authority to charge interest at arm's length rates, whereas New Zealand would apply its interest rate cap. In such a case, more disputes between tax authorities would result, most likely leading to additional mutual agreement procedures. Additional compliance costs would be inevitable, and it is not clear that the New Zealand Government would prevail.

An alternative approach would be for the US parent to provide a guarantee to the New Zealand subsidiary to reduce the cost of borrowing. In such circumstances, OECD guidance suggests that a guarantee fee should be paid to the parent company. The fact that OECD endorses the payment (and therefore deduction) of a guarantee fee reflects the fact that an interest rate anchored to the parent's cost of funds is not arm's length.

Agreement in principle to change in treatment of non-debt liabilities

We agree in principle with changes to require total assets to be calculated net of non-debt liabilities for consistency with the test employed in other jurisdictions, but we note that this would result in a material increase in gearing levels for some members, particularly those with large provisions, trade creditors or deferred tax liabilities.

The ability to use net current assets should be retained.

The Government is correct to highlight that current thin capitalisation rules work well given their aim of ensuring that excessive interest deductions are not used to shelter New Zealand sourced profits.

Most multinationals operating in New Zealand have relatively modest debt levels. EY's recent research (cited above) supports that conclusion. Members have seen no evidence to suggest that the

majority of multinationals are sheltering New Zealand sourced profits using excessive levels of related-party debt.

Members do however note that the changes to the treatment of non-debt liabilities will significantly increase calculated gearing levels, particularly for members with large provisions, trade creditors or deferred tax liabilities. That makes it more important for calculations to give fair value to assets and for the definition of non-debt liabilities to be well designed.

The ability to use net current asset values should be retained. It allows recognition of the market value of assets where this is not done for financial reporting purposes. Such market values are relevant to a lender of debt so it is appropriate the ability to use such values be retained.

The non-debt liabilities definition is based on the Australian definition, and – as in Australia - deferred tax should be excluded.

For some of our members, deferred tax liabilities for some entities can be substantial due to financial reporting rules, particularly under IFRS. Using a balance sheet approach, it is frequently necessary to account for liabilities on both permanent and timing differences which have no impact on cash flows. Users of financial information, including banks, frequently look through the large deferred tax liabilities reported by companies. Examples of problem areas include initial recognitions of a deferred tax liability on assets with no tax base, such as buildings, client lists and other intangibles acquired. Revaluations can also give rise to misleading results.

Compliance costs will increase

The ability for taxpayers to carry out a thin capitalisation calculation once each year should be retained.

We note that the changes to the thin capitalisation test will increase the burden of compliance for multinational taxpayers. An example is the proposal that only quarterly or daily calculations should be acceptable for the purposes of the measurement date of the thin capitalisation test. Absent any evidence that multinationals are abusing the annual method, we see no reason to change the rules. To do so would add a compliance burden to the majority in order to address a problem which has not been seen by our members and must be very rare in practice.

Existing financing arrangements should be grandparented

We are concerned that companies will not have sufficient time to adjust their affairs prior to the start of the first income year following enactment.

We note that firms controlled by non-residents acting together will be subject to the rules only on a prospective basis, on the basis that recent changes to the thin capitalisation rules would remain unchanged for some time. This logic applies equally to all multinationals.

Lenders have chosen to invest based on current law and instruments will have been costed on that basis. In some cases it may be prohibitively expensive to seek to unwind financing arrangements before applications of the new rule as investors have a legitimate expectation of a particular return. It would not be reasonable to expect borrowers to refinance based on a proposal in a discussion document which may be subject to significant amendment prior to enactment.

There should be a considerable grandparenting provision or a period during which restructuring of loans can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise as it would allow the vast majority of existing loans to mature.

6. Transfer pricing

Support for alignment with OECD Guidelines and appropriate Australian rules

We agree that New Zealand's transfer pricing regime should be aligned to international best practice. Consistency with the regimes applied in other jurisdictions will also help avoid the incidence of double taxation.

In our members' experience, since reform in 2012, the Australian transfer pricing rules have led to additional disputes between multinationals, the Australian Tax Office and overseas tax administrations. We expect that the proposals to reform the transfer pricing regime in New Zealand will result in a similar increase in the number of disputes, and we note the compliance costs associated with this.

Limited risk distributors commonly reflect commercial substance

The LRD model is one commonly used throughout the world. It is especially prominent in the pharmaceutical and technology industries, where a large amount of research and development happens earlier in the supply chain in foreign jurisdictions. The distribution activity undertaken in New Zealand happens at the end of the supply chain and is often relatively low in terms of the value-adding functions contributing to the system profits of the enterprise.

The implication of the discussion document seems to be that, in most cases, LRDs structures lack commercial reality and most risks are controlled by the New Zealand entity. More often, for these businesses the global marketing strategy is conducted offshore and tight control maintained over marketing spend, inventory levels and major business decisions of the LRD. The New Zealand subsidiary will have substantially smaller resources at its disposal and will often undertake market activation activity rather than development.

This point has previously been accepted by Inland Revenue. In one recent example, John Nash, Manager (International Revenue Strategy) was commented:

"In terms of the way we tax, is you tax the value-add. I wish it wasn't like this. But you can only tax what gets added in New Zealand and we're right at the end of the value chain. Unfortunately, that's the state of the industry in New Zealand; it's not necessarily a reflection of profit-shifting."

Applying the arm's length standard

We note that, in assessing the transfer prices employed by taxpayers and determining whether adjustment is appropriate, the Commissioner has the advantage of hindsight which our members will not have when entering into the transaction. Shifting the burden of proof onto our members in relation to transfer pricing matters could be problematic, if we are later required to show that the arrangement was arm's length based on an outcome we could not have predicted. The Commissioner should take care not to impose unrealistic requirements on members in relation to genuine, but underperforming, business ventures.

Opposition to time bar extension

Tax positions assessed in the year ended 31 March 2013 are now time barred, but under the proposals could be reopened for a further three years. Members consider that this is inappropriate; any changes should be prospective in their application only.

Some members have invested considerable time and money in negotiating APAs with Inland Revenue. It is possible that legislative changes could override the effect of these APAs, effectively penalising taxpayers whose intention it was to be proactive in managing transfer pricing risk in a constructive way with Inland Revenue. The agreements should be honoured given their lower risk to the New Zealand revenue base and the inequity that would be created should taxpayers need to renegotiate such agreements.

We consider that any need for the extension of the time bar is limited should the proposal to shift the burden of proof to the taxpayer be adopted. This is because, should the taxpayer have the burden of proof, the Commissioner's concerns in relation to accessing relevant information are mitigated by an ability to more readily adjust transfer pricing outcomes where the taxpayer is non-compliant.

In addition, the Government will already have access to improved information flows through country-by-country reporting and automatic exchanges of information between Revenue Authorities.

Further, although the proposed extension of the time bar is limited to transfer pricing matters, there are complications associated with an adjustment for the interactions between transfer pricing and other matters, including income tax and withholding tax. If an extension of the transfer pricing time

bar is pursued, it should be clear what delimits a "transfer pricing matter" from another, to avoid the Commissioner pursuing something as a transfer pricing matter to "get around" a more restrictive time bar for another regime.

Evidence and documentation requirements

Given that the revised transfer pricing rules would place a burden of proof on our members to show that their transfer pricing is arm's length, it is important that it is clear to members what is required. In other jurisdictions around the world, the legislation is notably more prescriptive and sets out clearly what is required in documentation.

In New Zealand, Inland Revenue does not habitually set out its requirements in a formal way which creates difficulty for multinationals attempting to assess their documentation requirements (in many cases, by centralised tax functions overseas). Inland Revenue should set out unambiguously what is required of taxpayers. Mere endorsement of the OECD Guidelines does not assist taxpayers with little understanding of the particular risks to the New Zealand revenue base to which Inland Revenue's concerns more specifically relate.

7. Administrative measures

Penalties for not providing information

Penalties for failure to provide transfer pricing information should not be imposed on New Zealand business officers and/or directors.

It is proposed that changes be made to allow a person to be convicted of an offence if they fail to provide information held by an associated offshore group member. The New Zealand subsidiary of a multinational tends to be small in the context of the group's global operations. Our members note that officers and/or directors of New Zealand subsidiaries will often have little or no ability to compel offshore parents to provide information. We submit that it is not appropriate to impose penalties on New Zealand officers and/or directors for this reason.

Non-cooperation

Obtaining information can be difficult for a small subsidiary of a multinational.

We note that some of the factors proposed in the discussion document that lead to a finding that a taxpayer is "non-cooperative" are wide in scope (e.g. failure to respond to Inland Revenue correspondence). We submit that there should be some acknowledgement that on occasion delays in

obtaining information are not driven by an unwillingness to provide information, but rather by the difficulties in obtaining information from within large organisations generally.

Collection of information

Additional information gathering powers are unlikely to be effective and should not proceed.

We submit that Inland Revenue is likely to have sufficient ability to collect information from large multinationals under existing rules by virtue of country-by-country reporting and automatic exchange of information.

As noted previously, the introduction of specific provisions that enable Inland Revenue to directly request information or documents offshore may be unlikely to result in Inland Revenue receiving information in a timelier manner, on the basis that delays in obtaining information tend to be attributable to the internal workings of large organisations rather than deliberate non-cooperation. This is particularly so in light of the size of New Zealand relative to other jurisdictions that multinationals operate in, rather than a result of unwillingness by large multinationals to provide information. Country-by-country reporting and automatic exchange of information arguably provides Inland Revenue with a better method of collecting information than the specific provisions proposed in the discussion documents.

Early payment of disputed tax

Payment of tax in dispute at an earlier stage of the disputes process is not appropriate. Large multinationals are unlikely to default on the tax due, with use of money interest being an inadequate form of recompense for taxpayers.

Taxpayers generally do not enter into a dispute with Inland Revenue to delay the payment of tax. Rather, there is a genuine dispute over the tax position taken and amount of tax payable. In this respect, large multinationals in dispute with Inland Revenue should not be treated differently from any other New Zealand taxpayer.

The use of money interest and late payment penalties regime should be a strong enough disincentive not to prolong a dispute. The power of use of money interest is further evidenced by taxpayers using tax pooling services to mitigate its effects.

8. Conclusion

AmCham believes that New Zealand's tax laws are currently among the best in the world. New Zealand has a strong tax treaty network, a proven and effective thin capitalisation regime and a well-established transfer pricing regime.

AmCham supports a coordinated global response to BEPS, and endorses the work of the G20 and OECD. To the extent that the New Zealand Government proposes implementing the OECD's recommendations, our members broadly support the Government's intentions. However, where the proposals extend beyond implementing OECD recommendations, we do not see the Government has sufficient justification to take unilateral action.

A coordinated global approach will lead to better outcomes for tax authorities and for taxpayers.

We understand these submissions may be the subject of a request under the Official Information Act 1982 and consent to their release.

Yours sincerely

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BELL GULLY

April 27, 2017

BEPS - Transfer pricing and PE avoidance
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
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Wellington, New Zealand 6140

policy.webmaster@ird.govt.nz

Comments on BEPS - Transfer pricing and permanent establishment avoidance

Dear Deputy Commissioner, Policy and Strategy:

We represent the Digital Economy Group (the "DEG"), an informal coalition of leading U.S. and non-U.S. software, information / content, social networking, and e-commerce companies that provide goods or services through digital and non-digital means. A number of the members of the DEG have business activities in New Zealand. We are writing to provide the comments of the DEG on the proposal to deem a New Zealand PE of a nonresident enterprise if a related entity carries out sales-related activities for the nonresident in New Zealand (the "PE Anti-Avoidance Rule"), as set forth in the discussion document entitled, "BEPS - Transfer pricing and permanent establishment avoidance" (the "Discussion Document"). Although our comments principally address the PE Anti-Avoidance Rule, we also provide some brief comments on the Discussion Document's transfer pricing and administrative proposals.

We thank the New Zealand Inland Revenue (the "Inland Revenue") for the opportunity to provide comments on the Discussion Document. We applaud the Inland Revenue for following a transparent approach of soliciting and considering comments on the PE Anti-Avoidance Rule. This approach is particularly welcome in cases such as this, where the proposed changes to domestic legislation deviate from international norms. We also applaud the Inland Revenue for including in the Discussion Document detailed examples that allow interested parties such as the DEG to identify and address the exact causes of the Inland Revenue's concern with certain business structures.

Historically, New Zealand has been a firm advocate that the fundamental concepts of international tax law, such as nexus, source, character, and the application of the arm's length principle, should be developed and agreed on a consensus basis, and implemented consistently among trading partners. Even before the BEPS consensus is implemented, we are seeing a small number of jurisdictions choose the path of unilateral actions, creating a significant risk of serious fragmentation of the consensus-based international

tax framework, if other jurisdictions follow that path. Despite these recent examples, we respectfully suggest that New Zealand should maintain its historic position as an advocate for consensus-based rules and uniform implementation.

Accordingly, for the reasons we discuss in this submission, we respectfully recommend that the Inland Revenue either withdraw the PE Anti-Avoidance Rule or, in the alternative, defer consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the BEPS Project recommendations on the common commercial structures that fall within the PE Anti-Avoidance Rule's scope. We respectfully request a meeting with representatives of the Inland Revenue and the New Zealand Treasury (and/or relevant Ministerial officials) to discuss further the points we raise in this submission.

Executive Summary

1. As requested in the Discussion Document, we provide a brief summary of our major points and recommendations in the order in which they appear in this submission.

    i. As proposed, the PE Anti-Avoidance Rule captures common commercial arrangements involving affiliated New Zealand entities that are not abusive. Transfer pricing adjustments, and not deemed PEs, are the appropriate response to any perceived undercompensation of the New Zealand sales support entity.

    ii. The PE Anti-Avoidance Rule creates almost a *per se* PE rule for many multinational groups that sell into New Zealand using a nonresident principal. Imposing direct tax on a nonresident on the grounds that a local affiliate performs *any* sales related activities would be a radical departure from the established norms for imposing direct tax on a nonresident and thus would constitute a "fundamental change[] to the current international tax framework."

    iii. We are not aware of any other jurisdiction, including Australia or the UK, that has adopted a rule similar in scope to the PE Anti-Avoidance Rule. The PE Anti-Avoidance Rule therefore represents the most extreme unilateral PE measure in the world.

    iv. The PE Anti-Avoidance Rule is inconsistent with the consensus approach of the OECD/G20 BEPS Project, which already has developed a consensus based recommendation for changes to the treaty law PE standard to address the in-market support structures on which the PE Anti-Avoidance Rule focuses. As the BEPS Project recommendations already are addressing the concerns the Discussion Document identifies, we believe that the more

appropriate course of action is to defer the consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the BEPS Project recommendations on the structures that are within the PE Anti-Avoidance Rule's scope.

v. We endorse the proposal to adopt the revised OECD Transfer Pricing Guidelines ("TPG") and conform the New Zealand transfer pricing rules to the rules in the TPG. We respectfully recommend that New Zealand not adopt New Zealand-specific transfer pricing rules that deviate from the consensus interpretation of the TPG.

vi. If New Zealand shifts the burden of proof in transfer pricing cases from the Inland Revenue to the taxpayer, we respectfully recommend that the taxpayer only be required to prove that a result is within the range of reasonable results. We also respectfully recommend that the existing four-year statute of limitations for transfer pricing assessments be retained.

vii. We respectfully recommend that multinationals only be considered "noncooperative" from a tax administration standpoint where there is a willful, reckless, or negligent disregard of the requirement to timely produce truthful information in response to an Inland Revenue information request. We also respectfully recommend that New Zealand preserve the existing payment rule for amounts in controversy, and require taxpayers to pay the disputed tax only once the dispute is resolved. In addition, given the new country-by-country reporting and automatic exchange of information requirements, we believe that there is no need to expand the Inland Revenue's information-gathering powers in the manner described in the Discussion Document.

Centralized Sales Structures

2. We applaud the inclusion of examples in the Appendix to explain the Inland Revenue's concerns with centralized sales structures. As proposed, however, the PE Anti-Avoidance Rule will include in its scope common commercial structures that are not abusive.

3. In Example 1, a multinational group sells remotely into New Zealand without establishing any actual business presence in New Zealand. The PE Anti-Avoidance Rule does not apply in this case. In Example 4, the PE Anti-Avoidance Rule also does not apply where a multinational group sells into New Zealand using an affiliated New Zealand reseller. In an important comment, the Discussion Document notes that the proposed changes to New Zealand's transfer

pricing rules will allow New Zealand to "appropriately tax" this structure.

4. In contrast, Example 3 states that the PE Anti-Avoidance Rule applies to a multinational group that sells remotely to New Zealand customers because a New Zealand affiliate performs sales support activities. The inference from these examples is that combining the centralized sales model with some degree of local presence is abusive.

5. We respectfully submit that the basic fact patterns in both Examples 3 and 4 reflect extremely common business models that companies in a wide range of business sectors employ for sound commercial reasons. Some of the business reasons for choosing the centralized sales model include: (i) efficient cash management due to a single legal entity receiving all customer payments; (ii) simplified intercompany invoicing; (iii) simplified foreign exchange hedging at the principal company level for all receivables; (iv) consistent enforcement of group legal and financial business policies through centralized customer contract approvals; (v) application of single contract terms and choice of law in customer and supplier contracts; (vi) single legal entity identified as responsible party to pursue or defend IP enforcement claims; (vii) centralized compliance responsibility for regulatory requirements at a single entity; (viii) cost efficiencies arising from hiring personnel who can perform regional roles in a central location; and (ix) avoided costs of implementing financial accounting system support for multiple revenue points and intercompany sales transactions.

6. From a policy standpoint, it is difficult to justify treating the fact pattern in Example 3 as inherently more prone to abuse than the fact pattern in Example 1. If remote sales into New Zealand with no local presence are not abusive, adding local activities that are appropriately compensated for their role in creating value under the revised OECD TPG, as incorporated into New Zealand law, should not change that conclusion.

7. We suspect that the real concern about this structure is expressed in Example 3 itself as an assumed fact: that "the New Zealand subsidiary is a paid a fee for its services . . . [that] generally only exceeds its costs by a small margin." If that indeed is the actual concern, then the proper response is a transfer pricing adjustment, not a deemed PE of the nonresident. We see no reason why the revised TPG, with the recent enhancements expressly written to assure that transfer pricing outcomes are in line with value creation in exactly these cases, would not provide the Inland Revenue with the appropriate tools to "appropriately tax" this structure, just as the revised TPG provide such tools to "appropriately tax" the structure in Example 4.

8. The discussion in Example 3 notes the concern that a proper transfer pricing review of the value created by the local subsidiary would not be possible "as a practical matter (largely due to a lack of visibility over the value added through

the entire supply chain)."[1] We believe that these concerns based on lack of transparency will be directly addressed through country-by-country reporting and the enhanced transfer pricing reporting requirements imposed by Action 13.

9. We note that the Discussion Document in Example 4 expressly states that one of the problematic features of structures involving a New Zealand reseller is that principal companies in regional hub structures "typically carr[y] on limited actual activities in relation to" New Zealand sales.[2] As a broad generalization, this assumption is incorrect. In most cases, a company centralizes important functions in regional hubs to maximize both the commercial efficiencies of the centralized sales model described above and the company's ability to achieve market penetration across the region. Of relevance to the proposed PE Anti-Avoidance Rule, however, Example 4 shows that even under the assumption that the principal company carries on "limited actual activities" related to New Zealand sales, a proper application of the TPG will address any cases of undercompensation of the New Zealand in-market distributor. There is no more (or less) reason to assume that the business activities of a centralized sales entity which acts as principal for an in-market support structure conducts "limited actual activities" related to New Zealand sales. Accordingly, it is difficult to see how the tax policy responses to the cases of Examples 3 and 4 can be different.

10. We also believe that the TPG give the Inland Revenue the necessary tools to address third party channel provider arrangements, as set forth in paragraphs 3.27 - 3.28 of the Discussion Document. If transfer pricing adjustments are the appropriate response to perceived abuses in connection with sales into New Zealand through an affiliated New Zealand reseller, as Example 4 clearly states, transfer pricing adjustments, and not deemed PEs, also are the appropriate response to undercompensated New Zealand support affiliates in channel provider arrangements.

New PE Standard Under the PE Anti-Avoidance Rule

11. The Discussion Document states that the proposed rule "is not trying to widen the accepted international definition of a PE in substance."[3] With respect, the proposal does exactly that, as it creates almost a *per se* rule that applies to business structures that cannot be regarded as abusive, and proposes a PE threshold based on less economically significant activities than anything in current tax treaties or in the BEPS-recommended changes to Article 5.

12. Specifically, the rule applies if an arrangement satisfies the four criteria set forth in paragraph 3.21 of the Discussion Document. Of these four criteria, in practice

[1] Discussion Document, Example 3, p. 49.

[2] Discussion Document, Example 4, p. 50.

[3] Discussion Document ¶ 3.2.

only two will be operative terms, as the first and the third criteria are neutral facts - i.e., whether a nonresident supplies goods or services to a person in New Zealand and whether some or all of the sales income is not attributed to a New Zealand PE of the nonresident - which facts by themselves cannot indicate whether a structure is abusive, since they will exist in every case where goods or services are supplied into New Zealand without the involvement of an affiliate acting as a reseller of the goods or services. Therefore, the second and fourth criteria are the relevant subjects for discussion, as those two criteria represent the elements of the proposed standard which are meant to define an abusive structure.

13. Under the second criterion, the PE Anti-Avoidance rule may apply if a related entity "carries out an activity in New Zealand in connection with [a] particular sale for the purpose of bringing it about." This is a far lower threshold of economic activity for creating tax nexus of a nonresident than even the "principal role" standard that BEPS Action 7 recommends. The BEPS standard requires a local affiliate to play "the principal role" leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, a much more substantive activity than "an activity … for the purpose of bringing" about the sale. Under the proposed criterion, a New Zealand affiliate could give rise to tax nexus of a nonresident enterprise if it plays *any* role leading to the conclusion of a sales contract by the nonresident. Further, the requirement in the Action 7 recommendation that the contracts be concluded without material modification by the enterprise was intended to describe cases where there is no material business judgment exercised by the nonresident enterprise at the moment of contract conclusion. That point is absent from the proposed rule, so that a PE could arise even if personnel of the nonresident were heavily involved in contract negotiation and acceptance. Although the Discussion Document expressly excepts auxiliary or preparatory activities (such as advertising and marketing) from the list of tainted activities,[4] a wide range of activities that have never been considered to give rise to a deemed dependent agent PE, such as collaborative product design, routine sales promotion, solicitation, tech support, warranty repairs, etc., could conceivably fall within the scope of this criterion and trigger the application of the rule.

14. We believe that it is difficult as a policy matter to justify imposing tax nexus on a nonresident enterprise based on such limited local activities performed by an affiliate which is appropriately compensated under the arm's length principle. The objective of the PE standard is to assess when a nonresident enterprise itself conducts sufficient business activity through its actual presence in a state to warrant direct taxation of the nonresident. In considering whether a nonresident should be subject to local tax by virtue of attribution theories based on a dependent agent or similar activity, that policy choice should take into account

[4] Discussion Document ¶ 3.22.

the fact that the local affiliate is fully taxable in that state.

15. Thus, a nonresident without premises at its disposal in a state should be subject to direct tax in that state only if the nonresident itself could be said to be in fact conducting its business in that state - i.e., concluding contracts - on a regular basis through a local person operating in that state. The "principal role" standard lowers the threshold for tax nexus but still is faithful to the premise that the dependent person must be performing those activities in the state which lead immediately to contract conclusion, without material involvement at that moment by the nonresident, before the nonresident may be subject to direct taxation in that state by virtue of the attributed activities.

16. Imposing direct tax on a nonresident on the grounds that a local affiliate performs *any* sales related activities would therefore be a radical departure from the established norms for imposing direct tax on a nonresident. It is difficult to reconcile this feature of the PE Anti-Avoidance Rule with the statement in the Discussion Draft that the proposed measures "are not intended to make any fundamental changes to the current international tax framework."[5]

17. Under the fourth criterion, the PE Anti-Avoidance Rule applies where an "arrangement defeats the purpose of [the relevant tax treaty's] PE provisions." Nothing in the hypothetical case of a nonresident enterprise selling remotely into New Zealand with the assistance of a local sales support affiliate defeats the "purpose" of the PE standard, which is to define when the actual commercial facts indicate that the nonresident seller itself has sufficient actual presence in a state to justify the state's imposition of direct tax on the nonresident. Thus, unless a particular arrangement has some unique hallmarks of treaty abuse, nothing in what is otherwise a common commercial arrangement in itself should be considered to defeat the "purpose" of the treaty.

18. The Discussion Document states that the objective of the fourth criterion is to assess whether supplies are made "through a PE in substance."[6] The Discussion Document then proposes five factors to use in determining whether this test is met. The first three factors (the commercial and economic reality of the arrangement, the relationship between the nonresident and the related entity in New Zealand, and the nature of the services carried out by the related entity) are exceedingly vague, and provide no particular guidance as to whether the nonresident has the requisite degree of physical or other business presence in New Zealand.

19. The fifth factor seems to be the key to the proposal, as that factor purports to list indicators of PE avoidance, which indeed is the policy focus of the proposal. It is

[5] Discussion Document ¶ 1.4.

[6] Discussion Document ¶ 3.24.

hard to see, however, that the proposed indicators (i.e., whether the arrangement involves a low tax jurisdiction, specialized services, or a related entity which is allocated a low amount of profit on the basis it is carrying out low value activities while having a number of well paid employees) actually point towards abusive structures.[7] Whether a principal company has a tax rate that is lower than the New Zealand rate has no relationship to whether activities actually conducted in New Zealand directly by or on behalf of a nonresident rise to a level that could justify imposing direct tax on the nonresident. This element of the proposal suggests that New Zealand intends to apply different PE standards to different trading partners based on whether a partner has a tax rate that is acceptably high from a New Zealand perspective. Whether the New Zealand affiliate performs "specialised" services and the amount of profit allocated to the New Zealand affiliate based on that entity's functions, assets and risks also are not relevant to whether the nonresident itself has the requisite degree of actual business presence in New Zealand to warrant direct taxation. Rather, these issues relate to whether the pricing of the relevant intercompany arrangements complies with the arm's length principle.

20. Only the fourth factor is relevant to whether a nonresident could be said to have the requisite physical presence in New Zealand, but this factor is the most radical feature of the proposal. The fourth factor allows the Inland Revenue to test whether a nonresident enterprise would have had a New Zealand PE but for the separate legal existence of the nonresident and a New Zealand affiliate. This factor is contrary to New Zealand's treaties, which include an article based on Article 5(7) of the OECD Model, as explained in paragraph 40 of the Article 5 Commentary: "It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, *such a subsidiary company constitutes an independent legal entity*." (emphasis added)

21. The practical consequence of this factor would be to create a New Zealand PE of a nonresident in every case in which the activity of the New Zealand affiliate is not preparatory or auxiliary, as the premises and personnel of the affiliate would be attributed to the nonresident. This factor therefore would create an almost *per se* PE rule for multinational groups with New Zealand sales support affiliates.

22. We are not aware of any other jurisdiction that has adopted a rule that eliminates the distinction between separate legal entities for the purpose of asserting a PE. This rule effectively imposes PE reporting obligations on all groups which sell remotely into New Zealand using a local affiliate. This element does not exist in other anti-avoidance rules, such as the Australian Multinational Anti-Avoidance

[7] We assume that the last two criteria refer to attributes of the New Zealand affiliate, but there is no indication in the text as to which entity is being referenced.

Law ("MAAL") or the UK Diverted Profits Tax ("DPT"). Accordingly, as proposed, the PE Anti-Avoidance Rule represents the most extreme unilateral PE measure in the world. We believe that such a rule would not be consistent with the historic policy and practice of New Zealand.

23. We also struggle to see the potential PE abuse in channel provider arrangements. As the Discussion Document acknowledges, multinational groups use channel provider arrangements for "good commercial reasons."[8] There is no doubt that the channel provider (a New Zealand taxpayer) is compensated at arm's length for its services because it is unrelated to the nonresident. In addition, since the channel provider has taken over some or all of the sales responsibilities, the logical inference is that there is less reason for PE concern than in a pure related party arrangement on the grounds that the New Zealand affiliate is less likely to play "the principal role" leading to the conclusion of the contract with the New Zealand customer. The Discussion Document nevertheless justifies a finding of a PE on the grounds that the nonresident and the channel provider are "working together" to sell to the New Zealand customer, and that the New Zealand affiliate therefore assists the nonresident by assisting the channel provider.

24. The Discussion Document does not provide any detail on the level of activity that could give rise to a PE in connection with a channel provider arrangement, leading to the conclusion that a local affiliate merely "working together" with the channel provider to pursue a sale could give rise to a PE. That standard would be remarkably low and ambiguous (e.g., would merely accompanying a channel provider to a customer site trigger the application of the rule?). That standard also would discourage nonresidents from engaging unrelated New Zealand channel providers to support New Zealand customers since such arrangements now would give rise to PE uncertainty in addition to requiring the nonresident to compensate both the channel provider and address the PE exposure arising due to the affiliate's activities.

25. We fully acknowledge that any tax administration must possess tools to properly address true cases of treaty abuse. The Discussion Document indicates that one such case is that in which a multinational group takes the position that a New Zealand affiliate performs only general support activities (e.g., marketing), but, in substance, the affiliate negotiates and concludes contracts on behalf of a nonresident.[9] As the Discussion Document appears to acknowledge, New Zealand's existing domestic and treaty law rules provide tools, including anti-abuse rules, that allow the Inland Revenue to address these arrangements. The fact that employing these tools may require resource intensive audits is not a sufficient justification for the radical legal change that the Discussion Document

[8] Discussion Document ¶ 3.29.

[9] *See* Discussion Document ¶ 3.13.

proposes. Furthermore, the introduction of the information gathering, transparency and cooperation measures the Discussion Document proposes will ultimately ease the Inland Revenue's administrative burden on audit, thereby reducing further the need for an unfocused rule of convenience like the PE Anti-Avoidance Rule.[10]

Profit Attribution Under the PE Anti-Avoidance Rule

26. The Discussion Document states that the Inland Revenue expects "a fairly significant amount of . . . sales income [to be] attributable to the deemed PE" under the PE Anti-Avoidance Rule.[11] We believe that this assumption is not likely to be correct in reality. Specifically, it is difficult to envision what additional profits could be attributed to a deemed PE with respect to in country sales activities where those activities already have been fully rewarded under the revised OECD TPG, as implemented in New Zealand law. The Discussion Document correctly acknowledges that income attributable to the nonresident's offshore activities will not be subject to direct tax in New Zealand.[12] Since in general all value other than value arising from the sales functions performed by the affiliate will have been created outside of New Zealand, the profit attribution result under the PE Anti-Avoidance Rule is likely to be zero in most, if not all, cases.

27. This result is even more likely for a deemed PE created under the proposed PE Anti-Avoidance Rule than is the case for deemed PEs arising under the current Article 5(5) or the BEPS Action 7 "the principal role" test, since the activities which give rise to a deemed PE under the PE Anti-Avoidance Rule almost invariably will create less value through the in-country functions, and involve the use of fewer assets, than deemed PEs arising under the other two rules.

The BEPS Project Addresses These Issues Through an International Consensus

28. The OECD/G20 BEPS Project constitutes "the most fundamental changes to international tax rules in almost a century."[13] From the beginning, the expressed goal of the BEPS Project has been to create a consensus set of revised international tax rules, and implement them consistently around the world.[14] The

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[10] *See* Discussion Document, Ch. 6.

[11] Discussion Document ¶ 3.36.

[12] Discussion Document ¶ 3.8.

[13] Statement of OECD Secretary-General, Angel Gurría, May 10, 2015, *available at* http://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm.

[14] *See* Action Plan on Base Erosion and Profit Shifting at 13 (2013) ("This Action Plan calls for . . . the adoption of new consensus-based approaches, including anti-abuse provisions, designed to prevent and counter base erosion and profit shifting."); Pascal Saint-Amans - The Face of BEPS, Tax Analysts, Dec. 22,

proposed PE Anti-Avoidance Rule clearly is a statement by New Zealand that it is prepared to follow the route of unilateral actions and depart from the consensus positions. With respect, we believe that decision would be shortsighted.

29. We note that many of the "in-market support structure" cases identified as "problematic" would be addressed directly by the new "the principal role" standard (and even by the current Article 5(5) standard in cases of actual abuse). The OECD/G20 consensus recommendation to change the OECD Model PE standard already has had an impact on company structures, even though the treaty ratification process has not yet been completed. Many multinational groups, including significant participants in the digital economy, have begun the process of reorganizing their commercial structures. These have included reorganizations of in-country sales and purchasing functions into resellers in multiple sales jurisdictions. Despite the commercial efficiencies of centralized sales structures noted above, groups are taking their lead from this new international tax consensus to reorganize their commercial structures in the direction encouraged by the BEPS Project.

30. Through the OECD/G20 transparency initiatives, including country-by-country reporting, these structural changes will become apparent in the coming years. These changes may not yet be visible to tax administrations which develop information through audit procedures, as those procedures necessarily focus on past years.

31. Accordingly, we believe that the ongoing implementation of the BEPS Project will address exactly the concerns identified in Examples 3 and 4 of the Discussion Document. We respectfully suggest that the more appropriate course of action at this point is to defer the consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the BEPS Project recommendations on the structures that are within the PE Anti-Avoidance Rule's scope.

32. We note that the Discussion Document mentions that some of New Zealand's treaty partners may not adopt the BEPS Action 7 recommendations, which the Discussion Draft asserts justifies a unilateral approach for New Zealand.[15] These passages transparently communicate that New Zealand is prepared to substitute a unilateral New Zealand standard for the OECD/G20 consensus, including in trading relationships where New Zealand's treaty partner chooses not to adopt the Action 7 recommendation. Essentially, New Zealand is challenging the OECD/G20 view that countries may choose whether or not to adopt the

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2014, ("A major reason for the project's two-year timeline, Saint-Amans said, is that the OECD had to move quickly to keep consensus among all countries and to prevent them from acting unilaterally to tackle sources of BEPS.").

[15] Discussion Document ¶ 2.9.

"principal role" rule in their treaties. In contrast with the four minimum standards to which all participants in the BEPS Project committed, participants are free to choose whether to incorporate the BEPS Action 7 recommendations in their treaties. New Zealand essentially is saying that New Zealand treaty partners do not have that choice.[16]

33. We observe that this approach is unusual for New Zealand, which has been a conscientious participant in the BEPS Project. This approach also is inconsistent with New Zealand's historic active role in helping to develop an OECD consensus to be applied on a consistent basis. In addition, the rule is ultimately inconsistent with the core treaty policy of establishing a framework for taxing nonresidents to which treaty partners bilaterally agree.

34. We note that some countries may be choosing to not adopt the Action 7 recommendations broadly through the Multilateral Instrument in order that they may choose selectively which treaty partners to approach with a view towards negotiating appropriate treaty changes on a bilateral basis. The Inland Revenue might consider this approach as a more targeted response to the perceived issues.

35. We respectfully suggest that unilateral actions intended to bypass the OECD/G20 consensus recommendations will not be healthy in the long run for New Zealand. If New Zealand adopts this rule, other jurisdictions may well reference the PE Anti-Avoidance Rule as a justification for adopting their own radical, nonconsensus positions. These positions ultimately will impact New Zealand enterprises engaging in cross-border trade, creating greater possibilities of double taxation and enhanced disputes on cross-border transactions.

Interaction with Treaty Network

36. We note the statement that the PE Anti-Avoidance Rule would apply "notwithstanding anything in a DTA."[17] We assume that this statement signals that the rule would be legislated in the same way as the current General Anti-Avoidance Rule ("GAAR"), ostensibly allowing enforcement of the rule outside the scope of New Zealand's tax treaties. We also note that the Discussion Document points to the UK DPT and the Australian DPT as prior examples of this approach.[18] We note, however, that a principal element of the justification that those taxes can be imposed outside the scope of tax treaties already in force

[16] We note that paragraph 2.9 of the Discussion Document suggests that additional measures to counter PE and transfer pricing avoidance are necessary as several trading partners will not adopt the BEPS treaty measures. We note that the revisions to the TPG are effective regardless of any adoption of the Action 7 proposals, so decisions by a country whether to adopt the Action 7 proposals will have no effect on the ability of New Zealand to apply the revised TPG, as incorporated into New Zealand law.

[17] Discussion Document ¶ 3.45.

[18] Discussion Document ¶¶ 2.15; 3.34.

is the assertion that the DPTs are not taxes on income or capital that are covered by Article 2.[19] While that view is subject to considerable doubt, since both DPTs in fact impose tax by reference to the profits of the enterprise, it is important to note that this justification cannot apply to support a treaty override under the New Zealand proposal. The PE Anti-Avoidance Rule sets a different definition of which nonresident enterprises are subject to the New Zealand corporate tax, but the tax that is imposed is indeed the same tax of general applicability imposed on all corporations. Thus, we believe that the PE Anti-Avoidance Rule conflicts with New Zealand's treaties, and any override based on GAAR-type principles could apply only in the case of actual abuse of the treaty.

37. In essence, the proposal constitutes a unilateral, selective rewriting of the PE Article for certain of New Zealand's treaty partners. We respectfully suggest that changes of that sort are best left to bilateral negotiations.

Substantive Transfer Pricing Rules

38. The Discussion Document characterizes transfer pricing as a "strategy" that multinational groups can use to shift profits out of New Zealand.[20] Transfer pricing is not a "strategy." Transfer pricing simply is the implementation of the legal requirement that associated enterprises conduct their affairs at arm's length. Since the arm's length principle applies to all cross-border transactions, transfer pricing rules must focus on providing clear guidance to taxpayers and tax administrations alike.

39. With that objective in mind, we endorse the proposal to adopt the revised OECD TPG and conform the New Zealand transfer pricing rules to the rules in the TPG. The TPG have proven to be a useful expression of international consensus. To preserve the benefit of this consensus, we respectfully recommend that New Zealand not adopt New Zealand-specific transfer pricing rules that deviate from the consensus interpretation of the TPG. One clear example of such a deviation is the Australian non-recognition / reconstruction rules. These rules are unique to Australia, are inconsistent with the rules in the TPG, and would make New Zealand an outlier from a transfer pricing standpoint if they were to be incorporated into New Zealand law.[21]

40. Every cross-border transaction involves another jurisdiction. Thus, every New Zealand specific transfer pricing rule or interpretation is likely to result in an increase in transfer pricing controversies. Such controversies will result in a

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[19] Discussion Document ¶ 2.11 ("The DPTs that have been proposed in Australia and enacted in the UK tax the diverted profits of large multinationals. Their DPTs are an anti-avoidance measure and are entirely separate taxes levied at a penal rate compared with income tax.").

[20] Discussion Document ¶ 5.7.

[21] *See* Discussion Document ¶¶ 5.34 - 5.40.

burden on cross-border trade, to the detriment of New Zealand residents.

Procedural Transfer Pricing Rules

41. The Discussion Document proposes to shift the burden of proof in transfer pricing cases from the Inland Revenue to the taxpayer.[22] In many cases, the relevant comparability analysis will produce a range of results, all of which could be arm's length.[23] Accordingly, we respectfully recommend that the principle be clear that the taxpayer only needs to prove that a result is within the range of reasonable results. An alternative approach, in which the taxpayer must prove that the specific result within that range is correct, is unworkable. Under that latter approach, taxpayers could never have certainty that their transfer pricing would be accepted since the Inland Revenue always could propose a different result within the arm's length range.

42. The Discussion Document also proposes to extend the "time bar" for transfer pricing assessments from four years after the end of the year in which a company provides the relevant return to the Inland Revenue to seven years after that date.[24] The Discussion Document justifies this proposal on the grounds that the non-arm's length nature of certain transfer pricing arrangements only becomes apparent after a longer period of time.[25] We respectfully recommend that the existing statute of limitations on transfer pricing assessments be retained. If, as the Discussion Document proposes, the burden of proving that a transaction is arm's length shifts to the taxpayer, a longer time bar is not necessary, since the taxpayer must affirmatively demonstrate, using the information at its disposal, including financial projections, the arm's length nature of an arrangement. In this case, the Inland Revenue has the opportunity to assess whether or not an arrangement will give rise to an arm's length result even for periods outside the assessment period.

43. In addition, extending the time bar for transfer pricing assessments, but not for other tax items, such as income tax, withholding tax, and indirect tax, could further complicate the audit process, because transfer pricing and other tax items often are interrelated.

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[22] Discussion Document ¶ 5.47.

[23] *See* OECD Transfer Pricing Guidelines, Ch. III ¶ 3.55 ("In some cases, it will be possible to apply the arm's length principle to arrive at a single figure (*e.g.* price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the most appropriate method or methods produces a range of figures all of which are relatively equally reliable.").

[24] *See* Discussion Document ¶¶ 5.67 - 5.72.

[25] Discussion Document ¶ 5.68.

Administrative Measures

44. The Discussion Document proposes to introduce new administrative measures to apply to multinational groups that are "noncooperative" with the Inland Revenue.[26] As a threshold matter, we note that many of the actions that the Discussion Document characterizes as "noncooperative," such as a "[f]ailure to comply within a statutory time-frame with Inland Revenue's reasonable requests" and a "failure to respond to Inland Revenue correspondence,"[27] may in fact reflect events that are beyond the taxpayer's control. Based on our members' experience, it is often difficult and time-consuming to procure the information that the Inland Revenue requests because of the large size of a multinational enterprise and the significant scope of the enterprise's activities. In addition, where the Inland Revenue requests a large volume of information, the enterprise may wish to obtain and provide information to a standard that is sufficient for the legal discovery process so as to avoid duplicating the effort a second time should an inquiry progress to litigation and, if necessary, seek the Inland Revenue's agreement to this.

45. Thus, based on our members' experience, the perceived delay in providing information requested to the Inland Revenue within the Inland Revenue's desired timeframe is generally attributable to the amount of time it takes any large enterprise to source information from within the organization. This delay is not attributable to any unwillingness to provide the information timely on the part of the taxpayer; rather, it typically is due to the constraints on those internal resources required to respond to large information requests received from multiple jurisdictions. Accordingly, we respectfully recommend that the Inland Revenue limit those actions that constitute evidence of "noncooperation" to actions that represent a willful, reckless, or negligent disregard of the requirement to timely produce truthful information in response to an Inland Revenue information request.

46. The Discussion Document proposes to require nonresident enterprises to pay tax that is the subject of a dispute before the dispute is resolved.[28] We respectfully recommend that New Zealand preserve the existing payment rule for amounts in controversy, and require taxpayers to pay the disputed tax only once the dispute is resolved.

47. Late payment interest fully compensates the New Zealand Treasury for any tax that is paid after the year to which the tax relates. Demanding payment of tax before a dispute has been resolved has been used in other jurisdictions as leverage

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[26] Discussion Document ¶ 6.13.

[27] Discussion Document ¶ 6.16.

[28] *See* Discussion Document ¶¶ 6.21 - 6.26.

to compel nonresident taxpayers to settle disputes due to lack of confidence in that jurisdiction's judicial and administrative review and refund procedures. We respectfully submit that New Zealand need not align itself with such a heavy handed approach to tax compliance.

48. The Discussion Document proposes to allow the Inland Revenue to request information from the group's New Zealand affiliate regarding non-New Zealand group members.[29] The Discussion Document further proposes to change the New Zealand criminal rules to allow a person to be convicted of a criminal offense if that person fails to provide information in response to such a request.[30] In addition, the Discussion Document proposes to allow the Inland Revenue to deem income attributable to a New Zealand affiliate or PE of a multinational group if the group fails to provide information in response to such a request.[31]

49. We believe that the proposed expansion of the Inland Revenue's information-gathering powers is unnecessary. The new country-by-country reporting and automatic exchange of information requirements, once fully implemented across the world, will provide the Inland Revenue with effective tools to obtain information regarding nonresident enterprises.

* * *

For the reasons noted above, we respectfully recommend that the Inland Revenue withdraw the PE Anti-Avoidance Rule and address perceived abuses under New Zealand's existing domestic and treaty law rules. In the alternative, we respectfully recommend that the Inland Revenue defer consideration of the PE Anti-Avoidance Rule until the New Zealand authorities have had an opportunity to evaluate the impact of the OECD/G20 BEPS Project recommendations on the common commercial structures that fall within the PE Anti-Avoidance Rule's scope. We also respectfully recommend that the Inland Revenue revise the Discussion Document's transfer pricing and administrative proposals in the manner described above.

We thank the Inland Revenue for the opportunity to provide our comments on the Discussion Document. We would welcome the opportunity to meet with the Inland Revenue to discuss our recommendations and are prepared to provide additional input as needed.

Yours sincerely,

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[29] Discussion Document ¶ 6.33.

[30] Discussion Document ¶ 6.35.

[31] Discussion Document ¶ 6.37.

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28 April 2017

BEPS – Transfer pricing and permanent establishment avoidance
C-/ Cath Atkins
Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
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Dear Cath

BEPS – TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE

The Corporate Taxpayers Group ("the Group") is writing to submit on the Government Discussion Document "BEPS – Transfer pricing and permanent establishment avoidance" (the "discussion document"). The Group is appreciative of the opportunity to submit on this discussion document and looks forward to discussing the proposals further with officials. The Group appreciates having had the opportunity to talk to Officials[1] about the discussion document and those discussions have informed some of the comments in this submission.

We provide a summary of our submission below. Further detail is included in the attached appendices:

- Appendix One: General comments
- Appendix Two: Permanent establishment avoidance
- Appendix Three: Amendments to the source rules
- Appendix Four: Transfer pricing rules
- Appendix Five: Administrative measures

Summary of our submission

The key points in our submission are:

General comments

- The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector and other stakeholders of the tax system adequate time to fully work through the issues which may arise from these proposals.

- The Group does not support proposals which deviate from what the OECD has recommended. These proposals will result in double taxation and remove taxpayers' rights under double tax agreements.

[1] Workshop with Sam Rowe, Gordon Witte, Steve Mack and Matt Cowen on 13 April 2017.

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- In the Group's view, many of the proposed changes negatively impact on the attractiveness of New Zealand as an investment destination. New Zealand's tax system plays a critical role in our competitive position with our major trading partners and competitors. At our workshop, Officials acknowledged that these proposals are in substance a Multinational Anti-avoidance Law ("MAAL") and they have many features of a Diverted Profits Tax (DPT).

- As inferred in paragraph 2.22 of the discussion document, many of the proposals in the document do not alter the outcomes under the existing law, should Inland Revenue use the full suite of tools currently available to it. The effect of these proposals is to potentially reduce compliance costs for Inland Revenue in enforcing the law against a very small number of taxpayers, but to significantly increase them for all taxpayers operating cross-border. Therefore the Group questions whether the changes are warranted, particularly given the negative impact that the perception of these changes may have on investment in New Zealand.

- The Group notes that if the rules governing New Zealand's tax system become too complex for foreign companies, they will no longer sell into New Zealand or may fundamentally change the way they sell into New Zealand, resulting in a loss of economic activity in relation to support functions.

- The Group appreciates that the Inland Revenue may find auditing multinational organisations "resource intensive" (as noted in paragraph 3.13), however this does not justify imposing large compliance costs on all compliant taxpayers.

- The Group considers that overall these proposals will be detrimental to tax certainty for taxpayers.

- The Group does not support the proposed application dates. Any changes implemented need to be complemented by appropriate grandparenting provisions for existing arrangements. Taxpayers need to be allowed a reasonable amount of time to undertake any necessary restructuring.

Permanent establishment ("PE") avoidance

- In the Group's view, departing from such core principles risks New Zealand falling out of step with the rest of the world, and in turn risking retaliatory action in jurisdictions in which we operate. New Zealand's best chance of ensuring that its exports are not overtaxed is to ensure that it does not act unilaterally and seek to assert taxing rights over revenue where the income earning activity (including IP) is located outside of New Zealand.

- The importance of DTAs cannot be understated: they exist to facilitate international trade. Having concluded a DTA with a foreign jurisdiction, New Zealand needs to be very cautious in implementing domestic legislation that has the effect of undermining the deal struck in a DTA. Such action risks not only undermining New Zealand's international reputation but also risks foreign jurisdictions taking retaliatory action against New Zealand companies operating "in" their jurisdiction.

- In our workshop we provided an example of a Group member with two employees in Japan. These employees are Japanese natives as it is necessary to have people on the ground who speak the language and understand the customs under which its customers operate. These employees talk to customers and translate communications back into orders that the Group member acts upon. In no way do the two Japanese employees have any role in concluding contracts or fulfilling orders. In the Group's view this type

of example should not give rise to a PE in Japan and cause allocation of profits to be taxed in Japan. However, in our workshop it was concluded by Officials that this was an example that was "close to the line" if the New Zealand proposals were to be applied to the arrangement.

- The Group submits that there are valid reasons why multinationals may conclude contracts outside of New Zealand. This is not necessarily about PE avoidance, but relates to the size and importance of New Zealand operations relative to the rest of the multinational organisation. New Zealand has a very small domestic economy, geographically remote from the rest of the world, and the activities undertaken in country reflect this. For example, in many instances it does not make sense for the multinational to have a legal team based in New Zealand. Linked to the point above, just because an individual in New Zealand is "well paid" does not mean that they are able to conclude contracts.

- A natural consequence of the introduction of these rules could be for non-residents to stop hiring any staff in New Zealand.

  It is critical that, if these proposals proceed, Inland Revenue should provide clear commentary for taxpayers on how it considers profits should be attributed to PEs. The rules cannot act as a "force of attraction" principle and seek to bring into the New Zealand tax base all New Zealand sales revenues simply because some functions are carried on in New Zealand. Any attribution of profit to New Zealand must reflect the actual degree of activity and effort in New Zealand – value added outside of New Zealand cannot be taxed in New Zealand.

- The Group submits that it should be clarified what the "purpose of the DTA's PE provisions" is in relation to the deeming of a PE in New Zealand (as per paragraphs 3.21 and 3.27). In the Group's view, whether an organisation has a PE or not, is an 'in or out' test – an organisation either has enough of a presence in New Zealand or not. The Group queries whether an organisation that is close to having a PE but does not have quite enough 'presence' could be considered to have defeated the purpose of the provisions.

- The Group notes that there are PE rules in DTAs and then there are the PE rules in the OECD Action 5 material. In the Group's view, the proposed rules in this discussion document are unnecessary, add complexity to the rules and disregard the purpose of DTAs.

- The rules proposed in paragraphs 3.21 and 3.27 both contain a criterion that "the arrangement defeats the purpose of the PE provisions". The Group submits that any such criteria should refer to the dominant purpose of the arrangement.

- This proposal should not have the effect of overriding New Zealand's DTAs. It is important that taxpayers continue to have access to MAP and arbitration procedures guaranteed in New Zealand's network of treaties.

Amendments to the source rules

- In the Group's view, the proposed changes to the source rules are unnecessary as the current source rules are sufficiently broad to capture any situations the Commissioner is concerned with.

Strengthening the transfer pricing rules

- Overall the Group does not believe that further strengthening of the transfer pricing rules are required. Inland Revenue already has a number of tools available to it and these tools should be applied.

- The Group does not support the extension of the time bar for transfer pricing positions to seven years. In the Group's view, this goes against Inland Revenue's Business Transformation principles and incentivises bad behaviour by Inland Revenue to not close out matters in a timely manner. In the Group's view, an adequately resourced Revenue should be able to complete this process within four years. The Group notes that there are significant costs involved in a transfer pricing dispute and extending the time bar to seven years will only increase these costs.

- The Group does not support shifting the burden of proof from the Commissioner to the taxpayer. However, if the onus does shift then it is important that the information required to prove that a particular transaction is arm's length must be limited to publicly available information / comparables. If the Commissioner seeks to rely on "secret information", then that information must be disclosed; and if such information cannot be disclosed with breaching confidentiality, then it is not appropriate that the Commissioner have regard to that information.

- The Group submits that there needs to be sufficient controls put in place when the Commissioner wishes to reconstruct a related party transaction. The Group notes that this power is essentially the Commissioner telling a company how to run its business and this kind of decision should only be made in exceptional circumstances. In the Group's view it must be clearly defined what activities / transactions are 'aggressive' and 'commercially irrational' – there needs to be structure and transparency around who decides this. Any powers of reconstruction need to be limited to only the most extreme circumstances and should only be assessed at the highest levels within Inland Revenue.

- The Group foresees difficulty in applying transfer pricing rules to investors acting in concert. The mere fact that there are unassociated parties coming together indicates there should already be arm's length pricing in place; i.e. there is natural tension to ensure each party is not receiving more than their fair share.

- It is important that Inland Revenue is appropriately resourced with skilled transfer pricing resource so that reviews can be completed efficiently (within four years) and the disputes process can run as intended - i.e. there are independent and impartial transfer pricing experts available to participate in taxpayer conferences and adjudication. There also needs to be sufficient resourcing to allow for an increase in the volume of APAs that will likely be sought if these proposals are enacted.

Administration measures

- There will need to be clear guidelines as to when a taxpayer may be deemed to be non-cooperative. In particular: (i) "non-cooperative" should have a legislated definition and that definition should confirm that a taxpayer is not considered non-cooperative merely because the taxpayer exercises its rights to dispute Inland Revenue's position or contest any steps Inland Revenue may take in an investigation; (ii) there should, in addition, be guidelines issued in the form of a Standard Practice Statement. These guidelines should record the process for determining whether a taxpayer is non-cooperative. In the Group's view this power should rest with a select few senior officials

within Inland Revenue. These officials should be independent from the officials auditing or otherwise engaged with the taxpayer.

- The Group submits that a taxpayer should have the right to apply to the High Court to challenge any decision of Inland Revenue to deem the taxpayer non-cooperative. Given the reputational damage and other consequences that could result from being deemed "non-cooperative" it is important that taxpayers have a means of challenging such a determination.

- The Group does not support the proposal to require taxpayers to pay the tax earlier in the disputes process. The general rule that disputed tax be payable only following final determination of any dispute should remain, except in cases where there is a risk of non-payment of tax found owing (in which case Inland Revenue already has power (see section 138I of the Tax Administration Act ("TAA")) to require early payment). Further, taxpayers are not incentivised to delay resolution of disputes (as suggested by the Discussion Document) given the imposition of use of money interest at rates considerably higher than commercial rates.

- The Group does not support the restriction on the use of tax pooling for disputes involving transfer pricing, the application of the source rules or tax payable under a DTA.

- The Group does not support the proposal to introduce a new statutory power to collect tax from wholly owned subsidiaries of multinationals in New Zealand. This is an unnecessary legislative amendment which may cause significant issues for New Zealand taxpayers in assessing their liabilities (in relation to lending covenants, the solvency test etc.). Inland Revenue already has powers to request assistance in the collection of tax under the *Convention on Mutual Administrative Assistance in Tax Matters*, therefore this rule is unnecessary. If the proposed rule were to proceed, Inland Revenue should be required to obtain a court order to impose on the New Zealand company liability for taxes owing by a different legal entity. The proposed rule is a major departure from the usual corporate law principle of limited liability and so requires judicial oversight in its application.

- The Group does not support a power for Inland Revenue to make a New Zealand entity legally responsible for providing information Inland Revenue may believe is held by another member of the multinational group. It is inappropriate for a New Zealand company to be subjected to monetary penalties and potentially criminal liability for failure to provide information over which that person has no control. If the proposed rule were to proceed, Inland Revenue should be required to obtain a court order to impose on the New Zealand entity or person liability for non-provision of such information. This would provide judicial oversight in respect of the breadth of the request and feasibility of complying with it, and as to whether the need for such an onerous power to be exercised is justified in the circumstances.

- The Group submits that it is not appropriate for Inland Revenue to have the power to impose a $100,000 penalty on taxpayers who fail to comply with section 17 or 21 of the TAA. Such a power should be left to the courts. This is especially so when taxpayers could be subject to penalties when information is not provided by a member of its multinational group and may have no control over whether the member provides the information or not.

- Section 21 in any event needs to be rewritten. It is arbitrary in its application (e.g. it is triggered by the non-response to an information request after 90 days without regard to whether that time-frame is reasonable in the circumstances, and is disproportionate

in its consequences (in denying a taxpayer access to the courts to contest the correctness of Inland Revenue's assessment)).

- Any changes implemented need to be complemented by appropriate grandparenting provisions for existing arrangements. Taxpayers need to be allowed a reasonable amount of time to undertake any necessary restructuring. At the very least the proposals, to the extent that they proceed, should only apply in respect of income years for which a tax position is taken after date of enactment.

We look forward to discussing this submission further with you.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ Bank New Zealand
5. ASB Bank Limited
6. Auckland International Airport Limited
7. Bank of New Zealand
8. Chorus Limited
9. Contact Energy Limited
10. Downer New Zealand Limited
11. Fisher & Paykel Healthcare Limited
12. Fletcher Building Limited
13. Fonterra Cooperative Group Limited
14. Genesis Energy Limited
15. IAG New Zealand Limited
16. Infratil Limited
17. Lion Pty Limited
18. Meridian Energy
19. Methanex New Zealand Limited
20. New Zealand Post Limited
21. New Zealand Racing Board
22. New Zealand Steel Limited
23. New Zealand Superannuation Fund
24. Opus International Consultants Limited
25. Origin Energy New Zealand Limited
26. Pacific Aluminium (New Zealand) Limited
27. Powerco Limited
28. Shell New Zealand (2011) Limited
29. SKYCITY Entertainment Group Limited
30. Sky Network Television Limited
31. Spark New Zealand Limited
32. Summerset Group Holdings Limited
33. Suncorp New Zealand
34. T & G Global Limited
35. The Todd Corporation Limited
36. Vodafone New Zealand Limited
37. Watercare Services Limited
38. Westpac New Zealand Limited
39. Z Energy Limited
40. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely,

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE: DETAILED SUBMISSION POINTS – GENERAL COMMENTS

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

1. General comments

Timeframes

1.1 The Group is very concerned that the compressed timeframe for consultation on these issues has not allowed the private sector and other stakeholders of the tax system adequate time to fully work through the issues which may arise from these proposals.

1.2 The timing of release of all three BEPS related documents (3 March 2017) was unfortunate as many taxpayers are heavily committed to tax compliance activities during the month of March.

1.3 Given the breadth of issues being consulted on and the potential overlap of proposals between this discussion document and *BEPS – Strengthening our interest limitation rules* the Group believes that a further round of consultation should take place later in 2017, prior to any changes being included in a tax bill.

General comments

1.4 The Group understands the need to address the wider BEPS issues in New Zealand and is generally supportive of targeted proposals to protect New Zealand's tax base. It is pleasing to see thought being taken on this issue. However, in the Group's view, the appropriate balance needs to be found between discouraging avoidance behaviour (including by simply using existing tax rules) and encouraging genuine commercial activity. <u>The Group does not think that this balance has been appropriately struck and does not support these proposals proceeding.</u>

1.5 It is also important that New Zealand does not rush into new rules before other jurisdictions, and that any measures remain proportional to the problem. As the Commissioner noted in the 2016 Multinational Compliance Focus Document: "*In the last few years Inland Revenue has placed an increased level of scrutiny on the tax practices of multinationals. I'm pleased we have found nearly all businesses open and willing to engage with us positively, and proud to contribute to New Zealand.*"[2]

1.6 In the Group's view, these proposals adopt an approach that targets the 'lowest common denominator', in that they apply to a large number of businesses, the majority of which are compliant. The Minister of Revenue, Hon. Judith Collins, noted in her speech to IFA releasing the three BEPS consultation documents: "*It is important that these BEPS measures do not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation*."[3] The Group considers that the current proposals are too broad and it would be more appropriate to target only those taxpayers who are non-compliant.

1.7 As inferred in paragraph 2.22 of the discussion document, many of the proposals in the document do not alter the outcomes under the existing law. Inland Revenue should use the full suite of tools currently available to it to resolve BEPS issues. Therefore the Group does not consider these changes warranted given the negative

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[2] http://www.ird.govt.nz/resources/6/2/62414b82-6ab8-4017-b04d-cc5d950cab47/compliance-focus-2016.pdf Page 1

[3] http://taxpolicy.ird.govt.nz/news/2017-03-03-beps-consultation-documents-released#speech

impact that the perception of these changes may have on investment in New Zealand. Consideration should be given to documenting why the structures / arrangements are unacceptable in an Inland Revenue publication, such as a revenue alert. Paragraph 2.22 states (emphasis added):

> *Inland Revenue is currently investigating or disputing several BEPS related cases. Nothing in this document is intended to prejudice any of those disputes or investigations. In particular, none of the proposed amendments in this discussion documents should be regarded as evidence that Inland Revenue cannot address the BEPS activities it is currently investigating or disputing under the current law, or that such BEPS activities are within the policy intent of the current law.*

1.8 In the Group's view, many of the changes proposed are being driven from a service delivery standpoint and not from a "what is best policy" point of view. Fundamental changes to New Zealand's tax system, such as those proposed in this discussion document, should have a clear policy intent behind them and must be for the benefit of New Zealand as a whole. Tax policy changes should not be overtly influenced by ease of application by Inland Revenue staff or be based on "nice to have" tax audit tools.

1.9 The Group's overarching concern is that the proposals contained in the issues paper have the potential to significantly impact on the cost of capital for New Zealand businesses. This will actively discourage foreign direct investment, resulting in a detrimental effect on the wider economy. The imposition of complex and burdensome tax rules will actively discourage foreign direct investment into New Zealand or multinational corporations from using New Zealand as a base for their operations. This is because other jurisdictions may become comparatively more attractive than New Zealand to invest in.

1.10 If foreign companies no longer invest into New Zealand because the tax rules are too onerous in comparison to the size of the potential market, this will have a direct impact on the New Zealand economy through reduced GDP (growth) and employment levels. There is an obvious negative effect of a loss of revenue for New Zealand (including GST to be claimed) and a reduction of consumer choice. In the Group's view, many of the proposed changes negatively impact the attractiveness of New Zealand as an investment destination. New Zealand's tax system plays a critical role in our competitive position with our major trading partners and competitors. The Group considers that it is important that New Zealand should provide a business environment that is at least as good as that which exists in competing countries, in particular our nearest and most significant competitor, Australia. In this respect it is important to consider the changes occurring in Australia and the perceived impact (whether negative or positive) of those changes.

1.11 Tax influences a company's decision to trade in a country, especially companies that are in a low margin business. For example, a member of the Group has noted that if the proposed US tax reforms go ahead and large duties are placed on imports, then it is likely that they will retreat from that market and look at other jurisdictions without such tax barriers. We do not want businesses discouraged from investing in New Zealand in a similar fashion.

1.12 The Group is of the view that there needs to be further analysis of the economic impact of these proposals before they can proceed, particularly in relation to the creation of a PE and attribution of profits. Tax changes that have the potential to increase the cost of capital and / or restrict the flow of foreign capital should not be made lightly and full consideration must be given to the economic impact of these

proposals. It is the Group's view that the proposals have the narrow focus of tax revenue enhancement and there is little evidence in the issues paper that the broader economic issues have been considered in any meaningful way. There must be a broader enquiry into the likely economic effect of these proposals before they proceed any further.

Certainty, compliance costs and competitiveness

1.13 The Group believes that a good tax system should be built around three principles in particular: certainty, compliance costs and competitiveness. As noted above, it is important that international competitiveness is maintained, especially in relation to Australia, as higher costs of doing in business in New Zealand flow through to less investment, fewer jobs and lower wealth. New Zealand's tax system plays a critical role in the attractiveness of New Zealand for both inbound and outbound investment. For New Zealand to remain competitive it is important that it is recognised that complex taxes can cause significant compliance cost for businesses.

1.14 The Group appreciates that Inland Revenue may find auditing multinational organisations "resource intensive" (as noted in paragraph 3.13). However this does not justify imposing large compliance costs on all compliant taxpayers. Compliance costs are a 'deadweight economic cost' that represent resources consumed for the production of very little (or nothing at all). These resources would be better employed creating jobs and raising the wealth of New Zealand. In the Group's view, these proposals will shift significant compliance costs onto taxpayers and this is only justified where the benefits outweigh the costs.

1.15 The Group considers that overall, these proposals will be detrimental to tax certainty for taxpayers. The proposals add unnecessary complexity to the rules and increase business risk by creating uncertain or unexpected tax outcomes. For the corporate sector, tax is not just a cost of doing business but is also a very significant risk by creating uncertain or unexpected outcomes. To lower business risks caused by the tax system, tax rules need to be administered and interpreted consistently and quickly, and should be as simple as possible to increase certainty. In the Group's view, the proposals as they currently stand increase complexity without any corresponding benefit.

Diverted Profits Tax and Multinational Anti-Avoidance Law

1.16 The Group is pleased to see that a diverted profits tax ("DPT") has not been recommended. In the Group's view, a DPT would discourage investment in New Zealand and may arbitrarily impose tax on compliant taxpayers. The Group supports the view in last year's Cabinet Paper that a tailored approach is more appropriate for New Zealand.[4]

1.17 As noted in the Cabinet Paper, a DPT "*could impact on foreign investor's perceptions of the predictability and fairness of New Zealand's tax system for foreign investment*". Even if a DPT has not been introduced, many of the proposed changes carry the same effect and there are elements of the proposals that are similar to a DPT (absent the punitive tax rate). Caution must be taken as the same arguments in relation to discouraging investment apply. The introduction of cumbersome and prescriptive rules reduces the attractiveness of New Zealand as an investment destination.

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[4] *Measures to strengthen transfer pricing rules and prevent permanent establishment avoidance – a Government Discussion Document*.

1.18 In our workshop, Officials indicated that the rules are intended to act as a multinational anti-avoidance law ("MAAL"). The Group cautions against introducing a MAAL for the same reasons it does not support a DPT. If it is intended that a MAAL is introduced, it should be consulted on as a MAAL and full consultation should be undertaken on its features, as was the case when Australia introduced its MAAL.

Interaction with existing treaty framework

1.19 In the Group's view, it is unclear how the proposals will fit into New Zealand's existing treaty framework. It is important that care is taken to consider the views of our treaty partners and their approach to this issue. If they respond in a similar way, there will be a risk that New Zealand's tax take is reduced (rather than being increased) due to other tax authorities taking the same action. Further, New Zealand businesses trading overseas may encounter greater taxes due to the changes, leading ultimately to less global trade which is clearly contrary to the Government's economic growth agenda.

1.20 It is noted that France has adopted a DPT, but in doing so, acknowledged that the definition of a permanent establishment in a relevant tax treaty would prevent the application of the DPT[5].

1.21 Officials have positioned the PE proposal as an avoidance rule however at our workshop with Officials it was suggested that the rule goes beyond even the expanded definition of a PE as included in the multilateral instrument and to be included in the OECD model treaty. Officials conceded that there may be instances where the expanded treaty definition does not apply but this domestic PE avoidance rule would deem a PE to exist. In the Group's view this takes the proposal beyond an avoidance rule and results in the fundamental shifting of the PE boundary beyond what has been agreed globally at OECD and with our treaty partners. This type of unilateral action is not justified particularly given the numerous occasions officials and successive Ministers of Revenue had publically confirmed New Zealand's commitment to the OECD BEPS project and the actions agreed globally. This action harms our reputation as an investment destination and a place where business can be conducted with ease.

Application date

1.22 The Group does not support the proposed application date for the administrative rules being the date of enactment of the relevant legislation. In the Group's view, it is fundamentally uncertain to have the date of enactment as the application date of a proposal. In particular, such a date is not appropriate where it introduces significant changes that may impact arrangements that have been in place for a number of years without previous challenge by the Commissioner.

1.23 As taxpayers have experienced from the recent enactment of the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 on 30 March 2017, having only two days' lead in time before the next income year begins does not give taxpayers adequate lead in time. The Group considers that taxpayers should be able to plan their future business with a degree of certainty and be afforded the opportunity to consider their options moving forward. All existing arrangements should have appropriate grandparenting.

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[5] https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-france-23-december-2016.pdf

1.24 The Group submits that the Commissioner should clearly establish the status of existing advanced pricing arrangements ("APAs") as a consequence of any changes enacted. The Group notes that binding rulings are binding on the Commissioner until there is a legislative change and queries whether the position will be the same for APAs. In the Group's view, it is important to establish a position to reduce any uncertainty taxpayers may face in light of the changing environment. The Group considers that all existing APAs should be grandparented and allowed to run their course, particularly given they often only run three years. Without grandparenting, taxpayers are dis-incentivised to engage with Inland Revenue in the interim as the high cost of obtaining an APA proportionally increases if the length of the APA is shortened.

APPENDIX TWO: DETAILED SUBMISSION POINTS – PERMANENT ESTABLISHMENT AVOIDANCE

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

2. Permanent establishment avoidance

Summary

2.1 The Group is concerned that these proposals are inconsistent with the purpose of DTAs. At a minimum, these proposals should only apply where New Zealand does not have an applicable DTA in place.

2.2 The Group is concerned about the sentiments expressed in paragraph 3.36 of the Discussion Document in relation to attribution to deemed PEs.

2.3 Taxpayers should have certainty about when these rules will apply by having a New Zealand dollar turnover threshold or ensuring that the threshold is set with reference to a previous fiscal year.

2.4 There are genuine commercial reasons why contracts may not be concluded in New Zealand. For example, it is not efficient for a multinational to have a legal team in every jurisdiction in which it operates. Having efficient and centralised management functions should not be prejudged as PE avoidance.

2.5 Inland Revenue needs to provide clear guidance to taxpayers about how profits should be attributed to PEs. The rules cannot act as a "force of attraction" principle and seek to bring into the tax base all New Zealand sales revenue simply because some functions are carried on in New Zealand. Any attribution of profit to New Zealand must reflect the actual degree of activity and effort in New Zealand – value added outside of New Zealand cannot be taxed in New Zealand.

Large multinational threshold

2.6 The Group submits that the large multinational threshold (non-residents part of a multinational group with more than €750 consolidated global turnover) should be given an equivalent New Zealand Dollar value (e.g. NZ$1.15b), as it would be inappropriate to have a large company fall in and out of the rules based on exchange rate volatility. This approach would be consistent with Australia's adoption of an AU$1b threshold. Alternatively, the Group submits that the threshold could adopt the wording of the OECD country-by-country threshold (*MNE groups with annual consolidated group revenue in the immediately preceding fiscal year of more than €750 million or a near equivalent amount in domestic currency*)[6]. This would also clarify the date / point at which the threshold is to be measured and provide certainty to taxpayers as to whether they meet the threshold.

Permanent establishment test

2.7 The Group submits that there are valid commercial reasons why multinationals may conclude contracts outside of New Zealand (for example to centralise management functions to improve management practices and reduce corporate risk). This is not necessarily about PE avoidance and obtaining a tax advantage, but relates to the size and importance of New Zealand relative to the rest of the multinational organisation.

[6] https://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf

For example, in many instances it does not make sense for the multinational to have a legal team based in New Zealand (and every other jurisdiction it operates in). Any proposed rule must focus on arrangements that are artificial and contrived to ensure that legitimate commercial arrangements are not captured.

2.8 The discussion document notes at paragraph 3.22 that "*only activities designed to bring about a particular sale should potentially result in a deemed PE*" and any activities that are merely preparatory or auxiliary are not sufficient to trigger a possible PE. The Group submits that additional guidance should be given as to the degree of connection required with sales into the New Zealand market, and whether this requires direct connection with a specifically identifiable sale that is in the contemplation of the New Zealand related party at the time it carries out its activity. As an example, will marketing activity that directs consumers to a website operated by a non-resident amount to the New Zealand related entity carrying out activity in connection with any resulting sale by the non-resident? Similar clarification should be provided as to the meaning of the "*for purpose of bringing it about*" and the requisite connection of the activities to the ultimately successful sale by the non-resident.

2.9 The Group considers that a natural consequence of the introduction of these rules could be for non-residents to stop hiring any staff in New Zealand. This will have a detrimental effect to the New Zealand economy, the cost of which needs to be weighed against any proposed changes.

2.10 The Group submits that it is important that any avoidance rule introduced is consistent with OECD and our international obligations. The current proposals fail on that front. For example OECD standard language in relation to concluding contracts is as follows:

> *"habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise via an intermediary"*

Whereas the proposed New Zealand rule encompasses the following:

> *Utilise New Zealand-based staff to support the sales function, through a New Zealand subsidiary, branch or "dependent" persons or entities contracted to an off-shore entity.*

2.11 It does not make sense to depart from language and concepts that are already internationally recognised and understood.

2.12 New Zealand should not be implementing rules when it would not be comfortable with other countries imposing those same rules on New Zealand exporters. The Group believes that the application of a similar rule to that being proposed in the discussion document by overseas jurisdictions presents a real risk to New Zealand's revenue base. This is especially relevant noting that the New Zealand economy is export driven with growing exports being the key plank in the Government's economic growth policy.

2.13 At our workshop with you we discussed the example of a New Zealand company selling product into Japan (or any other country). In this example the company had two employees on the ground in Japan who are responsible for liaising with clients and facilitating orders (noting that contracts are concluded outside of Japan). The reason for adopting this sales strategy is largely cultural. Experience has shown this

company that Japanese customers prefer to deal with someone who is in country, speaks Japanese and understands local customs.

2.14 In the Group's view, in this example the activity in Japan should not give rise to a permanent establishment. However, at the meeting Officials noted that based on the current proposal in the discussion document they consider this scenario to be 'close to the line' and could in fact give rise to a PE in Japan. The Group submits that if this is the case New Zealand must be prepared for Japan to deem a PE to exist and take a share of the profits. It is the opinion of the Group that this is a wholly undesirable outcome, yet there doesn't appear to be any consideration of the implications of overseas jurisdictions applying this type of PE avoidance rule.

2.15 At the workshop, Officials indicated that pure marketing activity undertaken by an organisation is not sufficient to give rise to a PE. However, if there is customisation for a particular sale, a line is crossed and a PE may exist with profits attributed to it accordingly. In this scenario the Group would expect that all 'business development' costs should be deductible. In many business models there can often be several lost sales for every sale that is actually converted. If New Zealand wishes to take a share of the completed sales, costs associated with the unsuccessful sales in New Zealand should also be deductible against the income of the "deemed PE".

2.16 As the Group has discussed with Officials, New Zealand has a very small domestic market. The reality of this is that, even if a particular taxpayer were inclined to use "profit-shifting" techniques, the application of such techniques to New Zealand operations would serve very little benefit. The majority of taxpayers just want to get on with running their business, which includes complying with all relevant tax laws. To do this, laws need to be clear and certain. The Group submits that the proposed PE avoidance rule creates significant uncertainty which would be a undesirable feature of our international tax rules.

2.17 The Group submits that the factors in determining whether the PE test is met (see paragraph 3.24 of the Discussion Document) should be clarified. In particular, the definition of "well paid" employees should be clarified as the Group considers that just because staff are "well paid", that does not mean that they have authority to conclude contracts. Recent transfer pricing questionnaires indicate that Inland Revenue considers staff to be "well paid" if they earn over $150,000 per annum. Members have noted that often they have a handful of New Zealand staff working overseas, managing a team of local staff in their overseas operations and that these New Zealand staff are paid well because it is necessary to have trustworthy staff overseeing operations. The level of pay does not relate to any decision-making ability. The Group also queries whether, in the case of a foreign PE of a New Zealand resident taxpayer, the Commissioner would expect a greater level of profit to be attributed to the PE on account of its employment of "well paid" staff.

2.18 The Group submits that guidance should be given as to the meaning of "low tax jurisdiction" (see paragraph 3.24). At this stage it is unclear what this refers to - whether it is a reference to the country's corporate tax rate, their tax system more broadly or some other measure. Given the importance of this as a factor and to provide some certainty to taxpayers, the Group submits that the Government should publish a list of countries whose tax systems it considers to have the features of a "low tax jurisdiction". The Group notes this approach was used successfully under New Zealand's former Foreign Investment Fund rules and a list of low tax jurisdictions is also included with Transfer Pricing Questionnaires issued by the Commissioner. For example, would the corporate tax rates of the important markets of the UK (17%)

and the US (15%, assuming announced reforms are enacted) deem them to be low tax jurisdictions?

2.19 Paragraph 3.36 of the discussion document states (emphasis added):

> ***We expect that the application of these principles will result in a fairly significant amount of the sales income being attributable to the deemed PE in most cases.*** *We also expect a material amount of net taxable profit to remain in the PE after the deduction of related expenses. In this regard, we note that New Zealand, like many countries, has not adopted the OECD's revised methodology for attributing profits to a PE. The OECD's revised methodology is also not currently reflected in many DTAs. New Zealand instead applies the earlier version of the OECD's methodology.*

2.20 The Group is concerned about the sentiments expressed in paragraph 3.36 and considers that the application of the proposals should be clarified, in particular what is meant by "fairly significant" and "material amount" in relation to sales income being attributable to the deemed PE and the net profit to remain (see paragraph 3.36). Thought should be given to the outcome if other countries also seek to grab a "fairly significant" and "material amount" of tax from New Zealand exporters. As noted previously, in the absence of clarity, taxpayers are likely to err on the side of caution and not place any personnel in New Zealand due to the lack of certainty in profit attribution. The Group acknowledges that foreign investors are willing to accept a New Zealand tax liability, but in making their decision rely on being able to cost future commercial arrangements accurately. It is important to make New Zealand as attractive as possible to encourage future inbound investment into New Zealand.

2.21 The Group notes that there are PE rules in DTAs, PE rules in the OECD Action 5 material and the PE rules as proposed in this discussion document. In the Group's view, the proposed rules as they are worded in this discussion document merely add complexity to the rules. The Group submits that the wording of Action 5 should be used where possible, as these are the standards that other countries will be implementing.

2.22 It is critical that, if these proposals proceed, Inland Revenue should provide clear commentary for taxpayers on how it considers profits should be attributed to PEs. The rules cannot act as a "force of attraction" principle and seek to bring into the New Zealand tax base all New Zealand sales revenues simply because some functions are carried on in New Zealand. Any attribution of profit to New Zealand must reflect the actual degree of activity and effort in New Zealand – value added outside of New Zealand cannot be taxed in New Zealand.

2.23 Under New Zealand's existing profit attribution principles, it is expected that the "profit calculated as being linked to the PE is in line with that which would be expected from a comparable business operating entirely at arm's-length."[7] In effect this means that the PE should earn a profit that is consistent with its functional profile. As this is not different to what is expected of legally separate entities, where a deemed PE is established by operation of the proposed rule, the profit taxable in New Zealand is unlikely to be higher than that currently provided to the New Zealand entity under the transfer pricing rules. In that event, the proposed rule would have no effect, other to impose significant and unnecessary compliance costs on the non-resident and risk non-residents eliminating jobs and investment in New Zealand.

2.24 In the Group's view, departing from such core principles risks New Zealand falling out of step with the rest of the world, in turn risking retaliatory action in jurisdictions

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7 http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-branches.html

in which we operate. New Zealand's best chance of ensuring that its exports are not overtaxed is to ensure that it does not act unilaterally and seek to assert taxing rights over revenue where the income earning activity (including IP) is located outside of New Zealand. It is extremely important to remember that the New Zealand rules do not stand alone and must be considered in the context of the worldwide environment.

Arrangements involving third party channel providers

2.25 The Group submits that the proposed rules should not cover arrangements where sale of supplies are made to a non-affiliated entity. It is intended that the proposed rules will also apply where an independent third party is interposed between the non-resident and the New Zealand customer as part of the arrangement. The discussion document suggests (at paragraph 3.29) that the non-resident and third party are working together to sell the particular goods or services to the end customer with the assistance of the related New Zealand entity.

2.26 In the Group's view, in the majority of these situations the non-resident *will not* have control over the sales activities of the third party and the arrangements do not amount to a "single arrangement" as discussed at paragraph 3.28, and therefore the proposed PE rules should not apply. The unrelated nature of the non-resident and the third party means that the transactions between them are at arm's length. The Group considers that distributors and retailers will operate independently and will not contravene the purpose of the DTA PE rules, noting that the sales by the third party are already within the New Zealand tax net.

2.27 The Group acknowledges that there may be limited situations where a related subsidiary works closely with, or directly controls, the activities of the unrelated third party. However, in the Group's experience, this arrangement does not occur in practice and if it does, then any detrimental tax effect may be able to be caught by the anti-avoidance rules in subsection GB of the Income Tax Act 2007. Accordingly, it is not justification for the proposal to fundamentally change New Zealand's approach to the concept of permanent establishment.

2.28 The Group submits that the proposed rules should be limited to situations where the sale is made directly by the non-resident to the New Zealand customer.

Purpose of the PE provisions

2.29 The rules proposed in paragraphs 3.21 and 3.27 both contain a criterion that "the arrangement defeats the purpose of the PE provisions". The Group submits that any such criterion should refer to the *dominant purpose* of the arrangement.

2.30 The Group also submits that it should be clarified what the "purpose of the DTA's PE provisions" is in relation to the deeming of a PE in New Zealand (as per paragraphs 3.21 and 3.27). In the Group's view, whether an organisation has a PE or not is an 'in or out' test – an organisation either has enough of a presence in New Zealand or not. The Group queries whether an organisation that is close to having a PE but doesn't have quite enough 'presence' could be considered to have defeated the purpose of the provisions.

2.31 The Group considers that the focus should be on artificial arrangements. There are many unusual commercial arrangements that are undertaken for genuine commercial reasons. The discussion document notes at paragraph 5.45 that there is an increasing variety of commercial arrangements being undertaken by multinationals and

consideration should be given to this. These arrangements are not inherently to avoid tax and merely represent the evolving nature of business.

2.32 The Group considers that this proposal should not have the effect of overriding New Zealand's DTAs. It is important that taxpayers continue to have access to MAP and arbitration procedures guaranteed in New Zealand's network of treaties.

2.33 The Group submits that these proposals should not apply to arrangements involving countries with which New Zealand has a DTA. Further, New Zealand should not be looking to impose a rule beyond what has been agreed by OECD. Any domestic PE avoidance rule should follow the language used in the OECD model treaty.

Inconsistencies

2.34 Paragraphs 3.21 and 3.27 set out proposed rules where PEs will be deemed to arise. Notwithstanding the Group's comments on these paragraphs above, the Group notes there is an inconsistency in terminology between paragraphs 3.21 and 3.27 of the discussion document. 3.21 describes an activity "in connection with", while 3.27 describes an activity "in relation to". The Group considers that this wording should be consistent in order to avoid any confusion.

2.35 Similarly, the Group also submits that the inconsistency between "that particular sale" in 3.21 and "the sale" in 3.27 should be consistent.

2.36 The Group notes that, at paragraph 3.21, a PE will be deemed to exist where certain criteria are met, including where "some or all of the sales income is not attributed to a New Zealand PE of the non-resident". These rules deal with deeming a PE to exist, not how to attribute profits as suggested by the above phrase. In the Group's view, the wording of this particular criterion does not make sense and should read as "none of the income is attributed to the PE" as, if some but not all of the income is attributed to the PE, any shortfall arises due to issues with the application of the profit attribution rules, and not the PE recognition rules.

Penalties

2.37 The Group does not agree with the proposal at paragraph 3.38 that "the current 100% penalty for taking an abusive tax position (under section 141D of the Tax Administration Act 1994) will also apply for the purposes of the proposed PE avoidance rule." The Group does not consider that the abusive tax position penalty, or even the unacceptable tax position penalty should automatically be applied in these situations. These penalties should only apply to extreme cases.

APPENDIX THREE: DETAILED SUBMISSION POINTS – AMENDMENTS TO THE SOURCE RULES

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

3. Amendments to the source rules

Summary

- Amendments are unnecessary as the existing source rules are comprehensive.
- The proposals unfairly penalise reinsured parties.

Proposed source rules

3.1 In the Group's view, the proposed changes to the source rules are unnecessary as the current source rules are sufficiently broad to capture any situations the Commissioner is concerned with. Under the current rules, if sales income has a New Zealand source under our domestic legislation it is taxable unless New Zealand is prevented from doing so under any applicable DTA.

3.2 Paragraphs 4.23 and 4.23 do not respect the existing source rules in part YD of the Income Tax Act 2007 which clearly contemplate apportionment through the use of the words "to the extent…". At the end of the day, New Zealand can only tax what has an actual source in New Zealand.

3.3 It is proposed that a new source rule be introduced under which income will have a New Zealand source if it is attributable to a PE in New Zealand. If a DTA applies in respect of the income, then the definition of a PE in that particular DTA will be used for this purpose. In the Group's view, the addition of this rule is circular and does not add anything to the rules. It is a belts and braces approach and it is hard to envisage a situation in which the proposed source rule will be employed that is not already covered.

Life insurance source rules

3.4 The Group understands the life insurance source rule proposal has been introduced due to the (theoretical) possibility that there may be tax relief for New Zealand sourced insurance if the reinsurer is resident in Singapore, Canada and Russia and doesn't have a PE in New Zealand. This is due to the fact that New Zealand's DTAs with these countries carve out life insurance income from the business profits exemption in Article 7 - i.e. non-resident life insurers who are residents of one of the above three countries receive an (unintended) tax advantage by being able to deduct reinsurance premiums.

3.5 The Group submits that the proposals unfairly penalise the reinsured by placing a significant burden on them with regard to the denial of deductions. In particular, they cannot be expected to have completeness of information regarding their insurers' place of tax residency and PE status in New Zealand.

APPENDIX FOUR: DETAILED SUBMISSION POINTS – TRANSFER PRICING RULES

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

4. Strengthening the transfer pricing rules

Summary

- Overall the Group does not believe that further strengthening of the transfer pricing rules are required. Inland Revenue already has a number of tools available to it and these tools should be applied. Inland Revenue should ensure that it is appropriately resourced with transfer pricing expertise in order to ensure that it is able to apply the rules as they currently stand, and do so within the current four year time bar period.

- Any powers of reconstruction need to be limited to only the most extreme circumstances and should only be assessed at the highest levels within Inland Revenue. The same applies for the deeming of any taxpayer to be non-cooperative.

- The Group does not support the extension of the time bar to seven years. This proposal is counter to Inland Revenue providing more certainty to taxpayers.

- The Group does not support shifting the burden of proof to taxpayers. The Group is concerned that Inland Revenue has access to comparables which are not available to taxpayers.

- The Group would like to see Inland Revenue provide an online resource setting out what OECD materials expect taxpayers to be following.

- The Group foresees difficulty in applying transfer pricing rules to investors acting in concert. The mere fact that there are unassociated parties coming together indicates there should already be arm's length pricing in place; i.e. there is natural tension to ensure each party is not receiving more than their fair share.

Time bar

4.1 The Group does not support the extension of the time bar for transfer pricing positions to seven years. This represents a 75% increase in the time bar, which in the Group's view, goes against Inland Revenue's customer centric approach and incentivises bad behaviour by Inland Revenue in not closing out matters in a timely manner. The Group understands that one of Inland Revenue's Business Transformation goals is to provide more "real time" advice, information and assurance, as well as to encourage taxpayers to "get it right from the start". This proposal is inconsistent with these principles.

4.2 The Group notes that Inland Revenue's compliance management approach for multinational enterprises has been to move to resolving issues with commercial transactions in real time. This approach has been achieved through provision of more pre-filing reviews and risk reviews and has allowed for practical certainty in a short period of time (well within the four year time bar).

4.3 The Group submits that the proposal to extend the time bar is particularly egregious given the nature of transfer pricing arrangements and disputes. These arrangements are fundamental part of the way a taxpayer structures their business and for this reason will generally span several income years. The Group notes these are not one-off events (like many other tax disputes) and there will be an impact year after year. To have tax years open for seven years leaves taxpayers open to far too much risk and uncertainty.

4.4 The discussion document asserts that the extension of the time bar will bring New Zealand in line with other countries. New Zealand operates in a smaller marketplace than these other countries, and the Group considers that an adequately resourced Revenue should be able to complete this process within four years.

4.5 The discussion document uses the time bar period of other jurisdictions as justification for increasing the time bar. However the Group submits that the selection of seven years is simply an example of "cherry picking" the worst option for taxpayers as this is the longest time bar (excluding China who applies a ten year time bar across all taxes, not just transfer pricing). As is shown from the table below (taken from paragraph 5.70 of the discussion document), the majority of jurisdictions do not differentiate between the time bar applying to transfer pricing vis-à-vis other tax issues. It is difficult to understand why Inland Revenue does not consider itself able to complete its transfer pricing reviews within the same time period that applies for other complicated areas of tax such as financial arrangements and tax avoidance.

Country	**Transfer pricing time bar**	**Standard time bar for other tax matters**
China	10 years	10 years
Australia	7 years	4 years
Canada	7 years	4 years
Malaysia	7 years	5 years
Hong Kong	6 years	6 years
Japan	6 years	5 years
Ireland	4 years	4 years
Germany	4 years	4 years
UK	4 years	4 years
US	3 years	3 years

4.6 The Group also submits that increasing the time bar puts New Zealand at risk of transfer pricing reassessments. In particular, other jurisdictions will have longer to claim a larger share of revenue which has been taxed in New Zealand. On the other hand, New Zealand businesses who find themselves subject to transfer pricing adjustments in New Zealand will not have the benefit of obtaining offsetting reassessments in the other jurisdiction if that country's time bar period is shorter (e.g. Hong Kong, Japan, Ireland, Germany, UK and US).

4.7 The Group submits that if the time bar is to be raised (which we disagree with), it should only be raised by one or two years and then only for non-cooperative taxpayers (see below for more discussion on what is a non-cooperative taxpayer). The Group notes that there are significant costs involved in a transfer pricing dispute and extending the time bar to seven years will only increase these costs. These costs will be compounded by the proposed administrative measures discussed below.

4.8 If the time bar is extended, the Group submits that the extended time bar should only apply to tax returns filed after the date of enactment. All tax returns filed before enactment should still be subject to the four year time bar in place when those returns were filed.

Burden of proof

4.9 The Group does not support shifting the burden of proof from the Commissioner to the taxpayer. In the Group's view this shift, coupled with an increase in the time bar, significantly increases compliance costs imposed on taxpayers without a sufficient trade off. The Group submits that the burden of proof should remain with the Commissioner if the taxpayer has been preparing documentation and has been open and transparent with the Commissioner.

4.10 However, if the onus does shift, then it is important that the information required to prove that a particular transaction is arm's length must be limited to publicly available information / comparables. If the Commissioner seeks to rely on "secret information", then that information must be disclosed or it cannot be relied on in in the dispute, including Court proceedings. If such information cannot be disclosed without breaching confidentiality, then it is not appropriate that the Commissioner have regard to that information.

4.11 The Group submits that if a taxpayer has sufficient proof that a transaction is within a range that can be considered arm's length, then Inland Revenue should not be able to tell a taxpayer that the transaction should have been completed at a different point within that range without providing the taxpayer with detailed economic analysis to support that position. For example, a taxpayer may have prepared a benchmarking study and identified an arm's length range of comparable margins between 2%-4% (supported by compliant transfer pricing documentation). The taxpayer may choose to apply the 2% margin because this is consistent with what they have done globally and is appropriate given the functional profiles of the relevant parties. However, it may be difficult for the taxpayer to negate an assertion by Inland Revenue that 4% is a more appropriate rate. In the Group's view, in this situation Inland Revenue should not be able to insist on the 4% result merely because it is also in the range supported by the taxpayer's benchmarking study.

OECD guidance

4.12 The Group submits that Inland Revenue should have links to the OECD Guidelines available on its website so that taxpayers can easily access this information. This will increase certainty as it is important that taxpayers have easy access to the rules that may affect them.

4.13 In the Group's view, if the OECD Guidelines are referenced in legislation it must be made clear what will occur if the OECD makes changes to the Guidelines. The Group submits that the legislation should contain reference to the OECD Guidelines that apply at the time a return is filed. The legislation should also reference reservations New Zealand may have entered in to and note that the guidelines will not apply to the extent of any of these.

4.14 Officials observe at 5.23 that *"Inland Revenue and taxpayers routinely apply the latest versions of the guidelines in cases from earlier years, as the guidelines are generally consistent with our existing law."* The Group notes that in practice this approach is only acceptable to the extent that it is not detrimental to the taxpayer.

It is inappropriate for the Commissioner to retrospectively rely on guidance that was not available to the taxpayer at the time its tax position was taken.

Arm's length conditions

4.15 It is proposed that the transfer pricing rules will move away from an assessment of the appropriateness of arm's length consideration to one of the "arm's length conditions". While little detail has been provided in the discussion document, Officials propose that this change will be aligned with the provisions present in Australia.

4.16 The Group notes that "arm's length conditions" are a much more difficult to identify than arm's length consideration. This is because the transfer pricing methods routinely applied in assessing cross-border transactions between associated parties typically identify only a comparable price or margin (or a range thereof) for a certain type of transaction.

4.17 Where the Commissioner seeks to look beyond this, to the wider terms and conditions of the arrangement, it becomes more difficult to support any proposed adjustment based on anything more than hypothetical constructs. The Group therefore submits that legislation and guidance must be clear as to the situations in which the Commissioner can establish "arm's length conditions" other than those identified by the taxpayer, and what must be provided to support this.

4.18 The Group is also concerned that the move away from arm's length consideration to "arm's length conditions" may see investigators seeking to adjust a taxpayer's result, rather than the underlying transactions. The Group considers that it is critical that any adjustment to align a taxpayer's result with "arm's length conditions" must be aligned with an adjustment to an identifiable transaction. This is because adjustments to different transactions may have different tax implications. For example, if a taxpayer enters into both services and royalty transactions with foreign associates and the Commissioner seeks to reassess the taxpayer's tax position, it is important for the taxpayer to know whether it is the services transaction or royalty transaction that is adjusted. This is because royalties typically attract withholding tax obligations, while service fees do not. These considerations flow through any attempt to gain equal and opposite treatment in the jurisdiction of the foreign related party.

Reconstruction of transactions

4.19 The Group notes the Commissioner already relies on an assessment of economic substance of cross-border associated party transactions when assessing the appropriateness of the consideration paid or earned under their legal form.

4.20 The Group submits that there need to be sufficient controls put in place when the Commissioner wishes to reconstruct a related party transaction. The Group notes that this power is essentially the Commissioner telling a company how to run its business, and this kind of decision should only be made in "exceptional circumstances". The Group notes that there are a large number of commercial tensions that work to influence a transaction and it should not be up to the Commissioner to judge the appropriateness of these (unless there are significant enough grounds to do so). In the Group's view, "exceptional circumstances" can be tested objectively (and is not measured by "uniqueness" as suggested by the discussion document at paragraph 5.39).

4.21 When reviewing transactions, Inland Revenue is doing so with the benefit of hindsight – something taxpayers do not have at the time they are running their business. When

considering the appropriateness of commercial arrangements, Inland Revenue should be putting themselves in the shoes of the taxpayer at the time the transaction / arrangement took place.

4.22 The Group submits that it must be clearly defined what activities / transactions are "aggressive" and "commercially irrational". It must be clear to taxpayers what the rules are and what the standard to be maintained is. The Group also submits that there needs to be structure and transparency around who decides what is an "aggressive" or "commercially irrational" transaction and the process for deciding this. This is necessary to protect taxpayers from overzealous investigators.

4.23 As noted for "arm's length conditions" above, the Group considers that it is important for any reconstruction by the Commissioner under the proposed reconstruction provisions to be aligned with an actual cross-border arrangement. This is particularly important where taxpayers may enter into a number of transactions, some of which attract withholding obligations.

Transfer pricing documentation

4.24 The Group appreciates that Officials do not currently consider it necessary to include a legislative requirement for taxpayers to prepare contemporaneous transfer pricing documentation. However, the Group is concerned about inconsistencies between statements in the discussion document and experience in practice.

4.25 Specifically, the Group notes that the discussion document states at paragraph 5.65 that:

> *"Inland Revenue would already apply a 'lack of reasonable care' penalty to incorrect transfer pricing positions taken by taxpayers who have failed to adequately document their transfer pricing positions <u>at the time those tax positions were taken</u>."*

In practice, the Group notes that it is common for penalties to be levied only where a taxpayer has failed to provide transfer pricing documentation following a request, and prior to commencement of an audit. This does not require the documentation to have been prepared prior to the filing of the income tax return. In light of this, the Group considers that clarity is needed if the Commissioner will now pursue penalties for "*lack of reasonable care*" if a taxpayer cannot prove that its documentation was prepared prior to the filing of the tax return.

4.26 The Group considers that this is critical for certainty and would prefer confirmation that contemporaneous documentation is required for penalty protection (as in the Australian legislation), over potential ambiguity.

The transfer pricing team / resources

4.27 It is important that Inland Revenue is appropriately resourced with skilled transfer pricing resource so that audits can be completed efficiently and the disputes process can run as intended (i.e. there are <u>independent</u> transfer pricing experts available to participate in taxpayer conferences, adjudication and arbitration). Currently there are so few transfer pricing Principal Advisors within Inland Revenue that it is not possible to obtain an independent / impartial review of a dispute and positions become entrenched.

4.28 There also needs to be sufficient resourcing to allow for an increase in the volume of APAs that will likely be sought if these proposals are enacted.

4.29 The Group notes that for many taxpayers the costs of obtaining an APA are too great for an APA to be a realistic option. Paragraph 5.40 of the discussion document encourages taxpayers to seek APAs to increase certainty. The Group notes that to obtain an APA is a long process that can often end up being very expensive. In the Group's view, if APAs are to be encouraged, it is important that the process is as streamlined as possible (and as noted above, sufficient resources must be allocated to a team dedicated to this work). The Group also notes that any position that would be agreed under a unilateral APA should be equally acceptable if supported through transfer pricing documentation outside the APA programme.

4.30 As mentioned above, an adequately resourced Revenue should be able to deal with transfer pricing issues within a reasonable time. Taxpayers should not be unfairly penalised with additional compliance costs and uncertainty because there is a lack of resources available.

Investors acting in concert

4.31 The Group sees real difficulty with the proposal to apply transfer-pricing rules to investors acting in concert. Where the investors do not have the same economic interests, natural pricing tension will ensure pricing for goods or services by one shareholder is at an arm's length rate. Treating a different group of persons as the one economic entity would not, therefore, reflect the economic reality unless all members of that group had the same proportional economic interests (for example, all were supplying the good or service in proportion to their shareholding).

4.32 The Group therefore suggests that the proposal should only apply where:

a. the New Zealand investment is 50 percent or more owned by non-residents; and

b. those non-residents have the same proportional economic interest in the transaction to which the transfer pricing rules are sought to be applied to.

4.33 Clarification should also be provided as to whether this association would also make transactions by members of the investors' groups with the New Zealand entity subject to the transfer pricing rules.

4.34 The Group notes that to the extent transactions are not priced correctly, there may be a transfer of value potentially giving rise to a deemed dividend. For example, if a New Zealand subsidiary were to pay greater than market value for goods purchased from a shareholder, the dividend rules would likely apply to this arrangement as there has been a transfer of value caused by a shareholding relationship.

APPENDIX FIVE: DETAILED SUBMISSION POINTS – ADMINISTRATIVE MEASURES

Disclaimer: no comments on practicalities or mechanics of the proposals are intended to be read as an endorsement of the proposals unless explicitly stated.

5. Administrative measures

Summary

- There will need to be clear guidelines as to when a taxpayer may be deemed to be "non-cooperative" and ideally this should be defined in legislation. A taxpayer should not be considered non-cooperative if they are just exercising their rights.

- A taxpayer should have the right to apply to the high Court to challenge any decision of Inland Revenue to deem the taxpayer non-cooperative.

- The Group does not support the requirement to have tax collected earlier in disputes or to allow tax to be collected from associated parties. The Group does not believe that multinationals represent a real credit risk.

- The Group does not support the restriction on the use of tax pooling for disputes involving transfer pricing.

- The Group does not support implementing penalties of $100,000 for failing to provide information.

- Any changes implemented need to be complemented by appropriate grandparenting provisions for existing arrangements. Taxpayers need to be allowed a reasonable amount of time to undertake any necessary restructuring.

Non-cooperation

5.1 The Group submits that a determination that a taxpayer is non-cooperative will not only have particular adverse consequences for the taxpayer under the proposed reforms, but could also have significant reputational consequences for the taxpayer. A taxpayer subject to disclosure obligations in connection with listed securities might for example (depending on the circumstances) be obliged to make public disclosure of any determination by Inland Revenue that it is non-cooperative. Given those consequences, there should be a clear statutory definition of non-cooperation as well as procedural safeguards in respect of such determination.

5.2 The statutory definition should state that a taxpayer is not non-cooperative merely because the taxpayer exercises its rights to dispute Inland Revenue's position or contest any steps Inland Revenue may take in an investigation. If a taxpayer were effectively subjected to detrimental consequences (in the form of a determination that the taxpayer is non-cooperative) as a consequence of contesting the validity of Inland Revenue's actions, then on the face of it the measure could be inconsistent with section 27(3) of the New Zealand Bill of Rights Act 1990 which provides that a person has the right to bring civil proceedings against, and to defend civil proceedings brought by, the Crown in the same way as civil proceedings between individuals.

5.3 In addition, there should be guidelines (in the form of a Standard Practice Statement) as to the process for determining that a taxpayer is non-cooperative. The power to make such a determination should rest with a relatively small number of senior officials within Inland Revenue, and any official making such a determination should

be independent from the personnel auditing/investigating or otherwise engaged with the taxpayer.

5.4 The statutory definition of non-cooperation and/or the Standard Practice Statement guidelines should also require advance written warning to be given prior to Inland Revenue determining that a taxpayer is non-cooperative. The taxpayer should receive written notice specifying the acts or omissions that Inland Revenue considers make the taxpayer uncooperative and affording the taxpayer a reasonable opportunity to respond to the warning and/or to remedy the actions or inactions that Inland Revenue considers may result in the taxpayer being uncooperative.

5.5 Finally, a taxpayer should have the right to apply to court to challenge any decision of Inland Revenue to deem it non-cooperative. As noted above, there could be significant reputational damage from being deemed "non-cooperative" and it is important that taxpayers have a means of effectively challenging such a determination.

Advance payment of tax in dispute

5.6 The Group considers that the proposal that taxpayers in certain cases be required to pay tax in dispute prior to determination of the dispute is unjustified. The proposal is unjustified for a number of reasons:

- The proposed rule is arbitrary, covering only disputes in relation to transfer pricing, the application of the source rules and tax payable under a double tax agreement ("DTA"). There is nothing special about these types of disputes to warrant the proposed rule;

- The general rule that disputed tax be payable only following final determination of any dispute should remain, except in cases where there is a risk of non-payment of tax found owing. In cases in which there is a risk of non-payment of tax ultimately found to be owing, Inland Revenue already has the power (see section 138I of the TAA) to require early payment;

- Multinational corporate taxpayers are not currently incentivised to delay resolution of disputes (as suggested at paragraph 6.21 of the Discussion Document) given the imposition of use of money interest at rates materially higher than commercial rates. While the ability to use tax pooling mitigates to some extent the effect of use of money interest being imposed at uncommercial rates, it does not eliminate it since the use of pooling involves its own costs;

- The Government has not provided evidence in the Discussion Document of any practice of multinational groups not paying the required tax found owing at the conclusion of a dispute. To the extent there is in a particular case a perceived risk of that occurring, Inland Revenue has the power to require advance payment as noted above; and

- Officials have suggested this measure is necessary to incentivise taxpayers to progress the dispute and resolve the matter. The Group challenges this suggestion. It is not appropriate for the time bar to be extended but then have taxpayers pay disputed tax earlier. Forcing a taxpayer to pay tax earlier (even if repayable at a later date) merely speeds up taxpayer 'burnout'.

5.7 The Group does not support the restriction on the use of tax pooling for disputes involving transfer pricing, the application of the source rules or tax payable under a

DTA. There appears to be no justification for tax pooling not being available in those cases. The tax pooling rules help mitigate the penal effect of use of money interest on underpaid tax applying at non-commercial rates for many taxpayers. The Discussion Document offers no justification as to why tax pooling should not be available. In the Group's view, tax pooling is a useful mechanism that allows some flexibility in situations where a taxpayer's exact liability is uncertain.

5.8 If this proposal does proceed the Group submits that a court order should be required to compel the earlier payment of tax in dispute. This will ensure that Inland Revenue does not require tax to be paid in advance of a dispute being resolved unless there is good reason to depart from the general rule that disputed tax should not be payable until it has been determined (or the taxpayer has accepted) that the disputed tax is in fact payable.

Collection of tax

5.9 The discussion document proposes allowing Inland Revenue to collect tax payable by a member of a large multinational group (as defined in the discussion document) from "any wholly owned subsidiary of the multinational in New Zealand". The proposed rule would also allow Inland Revenue to collect from a related New Zealand entity, tax on income attributed to a deemed PE of a non-resident. The discussion document states that such measures will "assist New Zealand in recovering tax payable by non-residents".

5.10 The Group is unaware of any existing difficulty arising from members of a multinational group not paying tax which is due and payable. The discussion document does not suggest there is (or provide any evidence of) any problem under existing law. The Group would be interested to understand the extent of any existing problem with multinational organisations not paying tax which is due and payable. The Group is sceptical that this is a real issue needing resolution, particularly when considering the relative size of these multinationals. The Group is also concerned that if other countries adopt a similar approach, New Zealand headquartered multinationals would be subject to punitive and unsubstantiated tax bills from the jurisdictions they operate in.

5.11 The Group is also concerned about the financial reporting and other commercial implications of a rule that would override the usual rule that members of a group are not jointly and severally liable for each other's liabilities. A rule imposing such liability could result in financial reporting implications for New Zealand members of multinational groups (e.g. the question could arise as to whether a contingent liability must be recognised). Such a rule would also complicate any assessment of risk by prospective lenders to or purchasers of the New Zealand business, since they would be required to inquire into not only the tax position of the particular New Zealand entities but the tax position of the wider group of which they form part. Significant compliance and other deadweight costs could result, in circumstances where no clear problem definition underlying the proposed rule is articulated in the discussion document.

5.12 Inland Revenue already has the power to request assistance from other jurisdictions in the collection of tax (see Convention on Mutual Administrative Assistance in Tax Matters). Given New Zealand's commitment to international cooperation in addressing BEPS, it is inappropriate for New Zealand to pursue a unilateral measure that cuts across an important internationally accepted norm of corporate law (that tax payable is payable by the particular company assessed, and is not subject to (in effect) a statutorily mandated guarantee by other members of the same group).

5.13 Finally, if the proposed rule does proceed, the Group submits that Inland Revenue should be required to obtain a court order to collect tax from an entity other than the entity against which it was assessed. The proposed rule is (for the reasons noted above) a significant departure from legal norms respecting the distinct and separate legal nature of individual entities, and as such should be subject to judicial oversight in its application.

Collection of information

The proposed power is unnecessary and has been rejected previously

5.14 The Group does not support the introduction of a power for Inland Revenue to make a New Zealand entity legally responsible for providing information that Inland Revenue may believe is held by another member of the multinational group. The TAA already provides that a person may be required to (and may commit an offence for omitting to) provide information held by foreign entities which that person controls. The discussion document proposes that the offence provisions in section 143 of the TAA be amended such that the New Zealand entity (a New Zealand resident or a New Zealand PE of a non-resident company) could be convicted of an offence for failing to provide information held by foreign associated persons of the New Zealand entity.

5.15 If the proposal proceeds, it would no longer be a defence under this offence provision that the New Zealand entity does not have possession or control of the information itself or over the entity that does hold the information. The New Zealand entity could therefore be convicted of an offence for acts or omissions of related entities which it does not control and in some cases cannot influence.

5.16 The Group notes that a similar provision was proposed in the Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill 2002. In that Bill, it was proposed that the Commissioner would have the power to request information from any persons "associated with the New Zealand resident".[8] This proposal would have resulted in a New Zealand resident taxpayer being required to produce to Inland Revenue information held by non-resident entities related to the taxpayer, even if the taxpayer has no practical control over those entities, and in circumstances where the entities have no bearing on the taxpayer's New Zealand tax obligations (essentially the rule proposed in the discussion document).

5.17 After submissions were received on the Bill, Inland Revenue accepted that the application of the rule should be restricted to apply only to foreign entities controlled by a New Zealand resident.[9] This narrowed rule was subsequently enacted.

The Australian and Canadian provisions referred to in the discussion document are not comparable to what the discussion document proposes

5.18 The discussion document (at paragraph 6.34) states that the proposed change would align New Zealand law with Australian and Canadian law and refers to section 264A of the Income Tax Assessment Act 1936 (Cth) and section 231.6 of the Income Tax Act RS C 1985 c 1. The Australian and Canadian provisions have very different consequences from what the Discussion Document proposes for New Zealand however.

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8 Clause 75.

9 See Inland Revenue *Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* ((November 2002) at 110.

5.19 Failure to comply with section 264A of the Income Tax Assessment Act 1936 (Cth) is not an offence. Section 264A(22) provides that:

> *A refusal or failure to comply with a request set out in an offshore information notice is not an offence.*

5.20 The Australian Master Tax Guide states that:[10]

> *[t]he only sanction for failure to comply with a notice is evidentiary, ie the information or documents which the taxpayer fails to provide will not be admissible in subsequent proceedings disputing the taxpayer's assessment.*

5.21 The consequence of not complying with the Australian rule reflects the purpose and nature of the rule. Fundamentally, it is an information gathering power to assist the Commissioner to assess the tax liability of the taxpayer, when that information is held offshore.[11] But unlike the general power to request information (such as in section 17 of the TAA in the New Zealand context) section 264A is obviously directed at the particular risk to the Commissioner of offshore information not being provided during an investigation and then selectively used in proceedings to dispute an assessment. The only consequence of not providing that information is that the taxpayer is not able to use that information to dispute any assessment. The Group also notes that the decision of the Australian Commissioner to issue an offshore information notice is amendable to judicial review (including as to the form and content of the notice itself).[12]

5.22 The Canadian provisions in section 231.6 of the Income Tax Act RS C 1985 c 1 specifically set out the right for the taxpayer to apply to a Judge for a review of the request for foreign based information or documentation.[13] The Judge then has the power to:

> *(a) confirm the requirement;*
> *(b) vary the requirement as the judge considers appropriate in the circumstances; or*
> *(c) set aside the requirement if the judge is satisfied that the requirement is unreasonable.*

5.23 Section 231.6(6) then provides:[14]

> *[f]or the purposes of paragraph 231.6(5)(c), the requirement to provide the information or document shall not be considered to be unreasonable because the information or document is under the control of or available to a non-resident person that is not controlled by the person served with the notice of the requirement under subsection 231.6(2) if that person is related to the non-resident person.*

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10 Michael Chow (ed) *Australian Master Tax Guide* (56th ed, CCH Australia Limited, Sydney, 2015) at [21-220].
11 *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia* [1994] FCA 1492; (1994) 54 FCR 75 at [30].
12 *FH Faulding and Co Ltd v the Commissioner of Taxation of the Commonwealth of Australia* at [34].
13 Income Tax Act RS C 1985 c 1, s 231.6(5).
14 Income Tax Act RS C 1985 c 1, s 231.6(6).

5.24 Case law has clarified that even if the person holding the information is related to the taxpayer, that will not in itself make the request a reasonable one.[15] That is, even if the information is held by a related party, there is a protection for the taxpayer in that the request must still be reasonable in the circumstances.

5.25 The penalty for not complying with the request is the prohibition, on the motion of the Minister, on introducing any foreign-based information or document covered by the request which was not complied with.[16] Only on conviction by the court is the taxpayer liable to a fine or term of imprisonment for not complying with the information request. The maximum penalty is a fine of $25,000 and a term of imprisonment of no more than 12 months.[17]

Inland Revenue can and should use existing powers

5.26 The discussion document acknowledges that Inland Revenue can and does seek information held by foreign entities using its exchange of information rights, but suggests that this is inadequate (at paragraph 6.32):

> *Recent improvements to the exchange of information between tax authorities are making it easier for Inland Revenue to request and exchange information that is held by offshore tax authorities. However, relying on an ability to request information indirectly from other tax authorities is not always adequate. In some cases, the relevant information is not held by the offshore tax authority and in other cases the foreign tax authority may be slow or unhelpful in responding to reasonable requests for information.*

5.27 The first aspect of this justification (that the foreign tax authority may not hold the information) is not compelling. DTA partners can, and do, exercise their own information-gathering powers to obtain the information that Inland Revenue requests under the DTA, just as Inland Revenue exercises its powers to obtain information requested by our DTA partners.

5.28 It is difficult to evaluate the second aspect of the justification (that the foreign tax authority may be slow or unhelpful in responding) without knowing how common this is. It is to be hoped that this is not often the case given that the DTA or Tax Information Exchange Agreement (as applicable) imposes an obligation on the foreign Government to comply with a valid request, and that New Zealand (presumably) complies with its obligations under the DTA or TIEA.

5.29 But to the extent Inland Revenue might sometimes encounter difficulties or delays in obtaining information from a foreign revenue authority, New Zealand companies may be in no better position yet (under the proposed rule) would be at risk of criminal sanctions and / or a significant monetary penalty if the information is not provided. For the New Zealand company, it is not simply a matter of requesting the information from (or forwarding on Inland Revenue's information request to) the relevant foreign affiliates and expecting that the information will be provided. The practical difficulties include:[18]

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15 See *Fidelity Investment Canada Ltd v Canada (Revenue Agency)* 2006 FC 551 and *Soft-Moc Inc v Canada (National Revenue)* 2013 FC 291.

16 Income Tax Act RS C 1985 c 1, s 231.6(8).

17 Income Tax Act RS C 1985 c 1, s 238(1).

18 For these same reasons, the Group is concerned that a New Zealand company's inability to provide information held by an associated foreign entity may be grounds to deem a taxpayer "non-cooperative". In fact, the non-provision of the information may be due to these very real practical constraints, and not to any desire to be uncooperative.

- Multinational groups may have hundreds or more legal entities operating in a large number of countries. If Inland Revenue were to have the power to issue an information request applicable to the whole group, it may be difficult or impossible for the New Zealand subsidiary to know even which legal entities may hold the information requested (and in which countries to make inquiries).

- Inland Revenue information requests are often very broadly worded, and may call for the production of large numbers (not infrequently thousands) of emails and other documents, which in turn could necessitate the review of an even greater number of documents to determine which are within the scope of the request. For such requests to apply not only to the New Zealand group but also to foreign associated persons could make the requests so costly and burdensome to comply with that compliance is for all practical purposes impossible.

- The New Zealand company will usually have no legal right to require a foreign associate to provide information to it. And even if the foreign associate is willing (in the interests of the group) to devote the time and resources necessary to assist the New Zealand company in locating and providing relevant documents, the foreign associate will need to consider whether it is appropriate to do so. For example, some of the information may be legally privileged. Local privacy and confidentiality laws will need to be considered.[19]

Alternative submission: if the proposal proceeds, judicial oversight is necessary

5.30 If the proposed rule were to proceed, Inland Revenue should be required to obtain a court order to impose on the New Zealand entity or person liability for non-provision of such information. This would provide judicial oversight in respect of the breadth of the request and feasibility of complying with it, and as to whether the need for such an onerous power to be exercised is justified in the circumstances.

5.31 In addition, the Group submits that if Inland Revenue is empowered to collect more information, this information can only be requested if it meets a "necessary and relevant" test. In the Group's view there needs to be a limit on the information that Inland Revenue can collect, especially where undue compliance costs are required to collect information that is not actually that important to the situation. In the Group's view, at the time information is requested, Inland Revenue should provide context as to why it is collecting information and how it is relevant to the taxpayer's New Zealand tax liability.

Penalties for not providing information

5.32 The Group submits that it is not appropriate for Inland Revenue to have the power to impose a $100,000 penalty on taxpayers who fail to comply with section 17 or section 21. A power to impose such a penalty should be left to the courts. This is especially so when taxpayers could be subject to penalties when information is not provided by a member of the same multinational group but over which the taxpayer may have no control.

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[19] These considerations were behind the need for FATCA to be implemented through Intergovernmental Agreements, such as that concluded between New Zealand and the United States. Had New Zealand financial institutions agreed to provide information directly to the United States (pursuant to an agreement with the United States Government under section 1471 of the Internal Revenue Code) they may have been in breach of their implied contractual obligation of confidentiality and/or their obligations under the Privacy Act 1993. For them to disclose the information to another Government to avoid a financial detriment (FATCA withholding) may not have been recognised as falling within the disclosure under compulsion of law exceptions to their confidentiality and Privacy Act obligations.

5.33 In the alternative, if Inland Revenue is given the power to impose what is effectively a $100,000 instant fine (without first taking proceedings), taxpayers must have the right to apply to the court seeking that the penalty be reduced or set aside. This is necessary as a minimum in order to meet the requirements of section 27 of the New Zealand Bill of Rights Act 1990.

Section 21 in any event should be rewritten or repealed

5.34 Section 21 of the TAA needs to be reviewed, and at a minimum rewritten (regardless of whether its scope is broadened to include situations of non-inclusion of income as suggested by the discussion document). Alternatively, section 21 should be repealed. Inland Revenue already has the power to request information under section 17 of the TAA and non-compliance with section 17 is an offence. Section 21 is arbitrary in its application (e.g. it is triggered by the non-response to an information request after 90 days without regard to whether that time-frame is reasonable in the circumstances) and is disproportionate in its consequences (in denying a taxpayer access to the courts to contest the correctness of Inland Revenue's assessment).

5.35 Denying a taxpayer access to the courts (and preventing a taxpayer from contesting the correctness of Inland Revenue's assessment) is an arbitrary and potentially disproportionate consequence of not responding to an information request. It is also inconsistent with section 27(3) of the New Zealand Bill of Rights Act 1990. At a minimum, this aspect of the section 21 should therefore be repealed. If a taxpayer does not comply with a request for information, the consequences should be the same as for non-compliance with section 17 and/or that information that should have been furnished in response to the request and is not cannot subsequently be used in proceedings. The consequence should not be the denial of dispute rights in respect of the relevant assessment.

Application dates for any Chapter 6 (administrative measures) proposals that do proceed

5.36 To the extent any of the Chapter 6 (administrative measures) proposals proceed, they should not apply from the date of enactment. The amendments would result in significant departures from legal norms and adversely affect the legal rights of taxpayers. Certain amendments could impose liability for tax, or, in respect of the obligation to provide information, on different legal entities solely because they are members of the same group.

5.37 The Group submits that there should be grandparenting of all existing arrangements at the time of enactment, with a five year sunset clause. A five year time period would provide a reasonable amount of time for multinationals to renegotiate agreements; noting that there will be many agreements within a single multinational which will need to be amended.

5.38 In the alternative, if a sunset clause as described above is not accepted, the proposals to the extent they proceed should apply only in respect of income years for which a tax position is taken after the date of enactment. In the Group’s view, there should be a lead time of at least one year after the date of enactment before the amendments take effect.

5.39 As taxpayers have experienced from the recent enactment of the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 on 30 March 2017, having only 2 days lead in time before the next income year starts does not give taxpayers adequate lead in time.

#015

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28 April 2017

BEPS – Transfer pricing and permanent establishment avoidance
C-/ Cath Atkins
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Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Cath

BEPS – TRANSFER PRICING AND PERMANENT ESTABLISHMENT AVOIDANCE

Deloitte welcomes the opportunity to comment on the Government Discussion Document "BEPS – Transfer pricing and permanent establishment avoidance" (the "discussion document").

General comments

We agree that Base Erosion and Profit Shifting ("BEPS") by multinational enterprises is a major concern, undermining tax authorities and stoking public feelings of unfairness. We appreciate that the Government is committed to taking decisive action to address BEPS issues to maintain the integrity of the New Zealand tax base.

We note that BEPS is a global problem, which requires a global solution. We are concerned that some of the proposals included in the discussion document would move the New Zealand transfer pricing environment beyond the global standard. We are of the view that unilateral action that goes beyond that established by the Organisation for Economic Cooperation and Development ("OECD") BEPS Action Plan is as likely to harm New Zealand's position in the global tax landscape, as it is to enhance it. In the case of some of the proposals, the Government should be conscious of the potential for retaliatory action by treaty partners that may be detrimental to New Zealand based multinationals.

While we recognise that some change is needed to ensure that the transfer pricing rules remain fit for purpose, we strongly recommend that the Government ensures that changes are clear and comprehensive, so as not to further stoke uncertainties in this complex area of our tax system.

Summary of submission

We have had opportunity to review and consider the submission prepared by the Corporate Taxpayers Group and largely concur with the submission points raised.

In addition to these points, we would also like to submit the following points:

- To ensure consistency in application of the new rules and expectations, a consistency committee should be established within Inland Revenue.

- The proposed changes to the permanent establishment ("PE") rules should be consistent with the OECD Action 7 changes and a greater level of analysis and guidance provided to alleviate uncertainty in application.

- If the transfer pricing rules are to refer to arm's length conditions, care should be taken in the drafting of the definition, noting limitations in data available to taxpayers in making such an assessment.

- The proposed reconstruction provisions must be carefully drafted so as to only apply in exceptional circumstances (with clarity provided as to what exceptional circumstances are). Appropriate safe guards and administrative processes should be implemented within Inland Revenue to provide oversight of the application of these provisions.

- The relationship between contemporaneous documentation and penalties should be clarified in legislation, as points made in the discussion document are inconsistent with what currently occurs in practice.

- The proposed changes should include an explicit de minimis threshold for the preparation of transfer pricing documentation or safe harbour guidance for certain transactions.

- The transfer pricing methods referred to in legislation should be aligned with those included in the OECD guidelines.

The above submission points are detailed further in the attached Appendix.

For any queries in relation to this submission, please contact Bart de Gouw on (+64 9 303 0889 or bdegouw@deloitte.co.nz).

Yours sincerely

DMMaitland

Diana Maitland
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for Deloitte Limited *(as trustee for the Deloitte Trading Trust)*

APPENDIX

Consistency committee

Recognising that the proposed changes to the transfer pricing rules amount to the biggest development since the inception of the New Zealand transfer pricing regime, we are conscious that there is potential for inconsistency in how the revised rules are applied by different investigators and principal advisors.

In light of this, we submit that a consistency committee should be established within Inland Revenue such that interpretation and application of the new rules is consistent across cases and taxpayers.

The committee should consist of Inland Revenue transfer pricing principal advisor(s) independent of the case being assessed as well as appropriate representatives from Legal Technical Services, the Office of the Chief Tax Counsel and the New Zealand Competent Authority as appropriate in the given situation or case.

A committee of this nature is considered crucial to the consistent application of the proposed new transfer pricing regime, so as to improve voluntary compliance, foster cooperation by taxpayers and avoid unnecessary disputes instigated by the inconsistent application of the rules.

In order to achieve these goals, we envisage the committee performing the following core functions:

1. Moderation
2. Escalation
3. Publication

These functions would, in conjunction with the other comments made in this submission, be expected to greatly enhance the operation of the transfer pricing rules and alleviate current nervousness from taxpayers as to their expected application in practice. We expand on these functions below.

1. Moderation

We see the current practices of the Inland Revenue's transfer pricing being prone to a level of inconsistency, with taxpayer experiences varying based on the team composition examining a case. We appreciate this may arise from a lack of resourcing within the unit and from a lack of central control and oversight over the conduct of transfer pricing investigations and reviews. As a result, taxpayers are left with uncertainty as to whether their transfer pricing arrangements will be considered appropriate in the event of review and the core concept of the arm's length principle is undermined.

In order for taxpayers to have certainty of treatment during transfer pricing investigations and disputes, Inland Revenue's transfer pricing unit needs to present a standardised and united front. This includes objective reviews with the same processes employed and expectations of taxpayers.

We therefore would envisage the consistency committee performing an internal governance function within the international audit unit, with the benefit of representation outside of the core transfer pricing team. It would provide guidance to principal advisors and investigators about review procedures, risk assessments and the expectations to be placed on taxpayers.

We would also suggest that a representative or representatives from the committee be present at transfer pricing dispute conferences involving potential adjustments of more than NZD1m (or some other appropriate threshold).

2. Escalation

Outside the disputes process, Inland Revenue does not currently have a process in place by which a taxpayer under review is able to escalate issues to a third party within Inland Revenue to ensure that the actions of Inland Revenue personnel are consistent with established policies, procedures and historic approaches.

We are aware that the Australian Tax Office ("ATO") enables taxpayers in the course of an investigation to escalate disagreements to more senior officers. We consider that the consistency committee could fulfil a similar function in New Zealand, offering an avenue through which a taxpayer under review may escalate a disagreement for consideration by a non-interested party. The implementation of this approach would strongly improve consistency for taxpayers, as any controversial action or request could be referred to the committee.

This could include, for example, instances where the proposed reconstruction provisions are to be invoked, or where a taxpayer is to be deemed "uncooperative" under the proposed administrative changes.

This process would ensure consistent application of the rules across taxpayers and may avoid some cases proceeding to audit or the disputes process.

3. Publication

The sum total of Inland Revenue publication on transfer pricing matters since the 2000 transfer pricing guidelines can be found in some 20 pages forming part of Inland Revenue's website. While this guidance is very helpful, few of these pages contain any reference to how the content is informed by, based in or interacts with the legislative provisions in practice that form the New Zealand transfer pricing rules.

In contrast, the ATO has published more than 20 detailed rulings on wide array of transfer pricing issues, along with supporting statements via the ATO website.

This lack of publication and development of standardised interpretation (to certain transactions or in certain situations) has contributed to the uncertainty that currently surrounds transfer pricing in New Zealand. Given the absence of judicial consideration of transfer pricing matters, the lack of more detailed guidance by Inland Revenue significantly increases the difficulty faced by taxpayers in determining an appropriate transfer pricing position and preparing high quality documentation in the current environment. Further clarity on Inland Revenue's expectations would be helpful.

We would therefore recommend that the committee be required to publish on a regular and confidential basis, the decisions in matters referred to it under the escalation function described above.

This publication would foster a strong base of interpretive guidance for taxpayers, which while not binding, would be sufficiently grounded in the New Zealand law.

Permanent establishment avoidance

Consistency with OECD

The discussion document proposes significant changes to the domestic PE rules. These changes seek to align New Zealand's domestic PE rules with those found in the Australian Multilateral Anti-Avoidance Law ("MAAL")[1], and the UK diverted profits tax ("DPT")[2].

Currently the PE rules as contained in New Zealand's double tax agreement ("DTA") network generally require that a person in New Zealand *"has and habitually exercises an authority to substantially negotiate or conclude contracts on behalf of the non-resident"* in order for a PE of the non-resident to arise.[3]

The revised OECD requirement would require a person to *"habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"* before a PE of the non-resident arises.[4]

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[1] Income Tax Assessment Act 1936, s 177DA
[2] Finance Act 2015, part 3
[3] Article 5, New Zealand – Australia DTA used as an example
[4] OECD, *Action 7: 2015 Final Report*, Section A

In contrast, the proposals outlined in the discussion document indicate that a PE will be deemed to exist where a person in New Zealand performs any activity in connection with sales by the non-resident where that activity has the purpose of bringing it about. The only restriction on this is that the arrangement must "defeat the purpose" of the PE provisions of the relevant DTA.

The proposed New Zealand rule as currently drafted is inherently broader than the revised OECD provision, despite the claim that this is not the intention.[5] We consider that based on the discussion document, a significantly larger number of business arrangements may be deemed to create a PE in New Zealand than would be the case under a strict application of the OECD rule. This creates inconsistency and uncertainty for taxpayers looking to determine the tax obligations arising from their legitimate commercial operations, and may lead to an increase in double taxation or retaliatory action by treaty partners.

As such, we submit that the PE definition included in the proposals should be made consistent with that established by the OECD. Alternatively, specific and comprehensive examples should be provided as to when and how this new rule would apply.

The discussion document further indicates that the proposals are intended to be an anti-avoidance rule, which may remove recourse of affected businesses for competent authority intervention under DTA mutual agreement procedures. Assuming this is the intention, this result is unacceptable for taxpayer certainty and fairness.

In contrast to the Australian MAAL and UK DPT rules, which only apply where erosion of the tax base occurs[6], the proposed New Zealand rule does not appear to consider the tax impact of any structure that would be deemed to create a PE.

Attribution of income and expenditure

Finally, the discussion document assumes that the application of the proposal would result in a *"fairly significant amount of the sales income being attributable to the PE"* with a *"material amount of taxable profit to remain".*[7] These statements neglect to consider the application of the profit attribution rules, which broadly require the level of taxable profit or loss to align with the functions, assets and risks of the non-resident in New Zealand as if it were an independent entity.

If therefore the New Zealand related party and the PE are the same functional entity, performing the same functions, utilising the same assets and incurring the same risks, there is no basis on which to expect a greater level of profit (or loss) to arise under the deemed PE proposal than already arises through the application of current legislation. However, the proposed rule would impose significant additional compliance costs for non-residents selling goods and services into New Zealand.

In light of the above, we submit that the Government should more fully analyse the proposed PE anti-avoidance rule, including providing guidance on the expectations of how income and expenditure would be attributed to the PE and the anticipated gains for the New Zealand tax base. In our view, the rule is as likely as not to be detrimental to the New Zealand tax base, as multinationals may eliminate New Zealand based jobs to ensure no deemed PE arises in the absence of further guidance.

Carve out for distributors

The discussion document states at paragraph 3.31 that the proposed rule as it applies to third party channel providers is not intended to apply to a "standard distributor type arrangement", however no indication is given as to how this exclusion would be achieved.

We submit that in the event that the proposal is adopted, care must be taken to ensure that the legislation is sufficiently clear as to the situations that are captured and those that are not captured by the rule.

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[5] Paragraph 3.2

[6] The MAAL requires a "tax benefit" to arise, while the DPT excludes situations where transfer pricing has resulted in the correct amount of tax being paid.

[7] Paragraph 3.36

Arm's lengths conditions

The discussion document proposes to amend the legislation from "arm's length consideration" to "arm's lengths conditions" to allow for the consideration of all "relevant conditions" to determine whether transactions comply with the arm's length principle.

The discussion document does not elaborate on the criteria to be assessed by a taxpayer in order to satisfy the proposed burden of proof.

Care should be taken when drafting the New Zealand definition of "arm's length conditions" such that it recognises

- The availability of comparable company data;
- The fact that benchmarking does not necessarily allow for the identification and assessment of a number of the comparable circumstances listed in the Australian definition; and
- That some legitimate associated party arrangements only exist because of the related nature of the parties and may not have identifiable analogues between independent parties.

We note that it is already common practice for the broader conditions of a certain arrangement to be taken into account in determining whether an amount is an arm's length amount for the purposes of the current transfer pricing rules.

We submit that any proposed adjustment to a taxpayer's transfer prices by Inland Revenue must be supported by more than an assertion as to different conditions, and should not be simply a disagreement with the point achieved or selected within an arm's length range. An appropriate threshold might be that the actual conditions of an arrangement must be evidenced to be materially different to the arm's length conditions before any adjustment can be made.

Reconstruction of transactions

The discussion document proposes to grant the ability for Inland Revenue to reconstruct or disregard certain transactions that it believes are not commercially rational.

While we understand that economic substance is an important consideration in determining the appropriateness of transfer prices between associated parties, it is also important that the rules do not unnecessarily impede arrangements that are only possible due to the related nature of the parties.

As noted in the discussion document, OECD transfer pricing guidelines provide that reconstruction type powers should only be applied in "exceptional circumstances". However, the current proposal does not intend to include reference to this threshold, prima facie allowing Inland Revenue broader reconstruction powers. We consider that this is dangerous for taxpayer certainty.

It is noted that the discussion document suggests that the New Zealand reconstruction provision will be drafted based on the Australian rules as included at subdivision 815-130 of the Income Tax Assessment Act 1997. We submit that care should be taken to ensure that the drafting of the New Zealand provisions is sufficiently detailed such that it will only apply in "exceptional circumstances". This should include a clear set of criteria against which taxpayers may assess their arrangements in the course of determining their income tax position.

In the event that the reconstruction provisions are enacted, there must be appropriate checks and balances to ensure that the provisions are not invoked inconsistently (see above in regards to a consistency committee).

Transfer pricing documentation requirements

Contemporaneous documentation

The discussion document notes that it is not currently proposed to require taxpayers to update and file transfer pricing documentation on an annual basis or impose specific penalties for a lack of documentation. However, it also notes that "*Inland Revenue would already apply a "lack of reasonable*

care" penalty to incorrect transfer pricing positions to be taxpayers who have failed to adequately document their transfer pricing positions at the time those tax positions were taken".

In essence, these statements are contradictory and inconsistent with our experience with Inland Revenue during transfer pricing reviews and disputes.

In our view, the proposal amounts to an implicit contemporaneous transfer pricing documentation requirement. Whether stated explicitly or not, the imposition of penalties for "lack of reasonable care" where taxpayers have not documented their transfer pricing positions "at the time" the position was taken creates a requirement for contemporaneous transfer pricing documentation.

We suggest that clarification is required on this point. If Inland Revenue's position is as described above, then this should be explicitly prescribed in legislation.

We submit that an approach consistent with that taken in Australia should be adopted to clarify the relationship between contemporaneous documentation and penalties. This should be accompanied by a prescribed de minimis threshold for smaller taxpayers or safe harbour guidance for certain types of transactions, as discussed below.

De minimis threshold and safe harbour guidance

A contemporaneous transfer pricing documentation requirement, as implied by the discussion document, would impose a significant burden on smaller taxpayers and those with only small or simple cross-border associated party transactions.

While we acknowledge that it is expected for large multinationals to prepare transfer pricing documentation as part of their routine compliance practices, and for the most part they do so (though this may not currently be contemporaneous), small and medium enterprises ("SMEs")[8] have little guidance from which to determine whether they should prepare documentation and how comprehensive this should be (other than current references to a "cost / risk" approach).

We recommend that the proposed changes to the transfer pricing rules include a prescribed de minimis documentation threshold, with taxpayers falling below the threshold exempted from preparing transfer pricing documentation (assuming they self-assess against a relevant set of criteria), with routine business records used to establish reasonable care. The de minims threshold could be set based on New Zealand revenue or the quantum of cross-border associated party transactions.

An alternative would be to follow the Australian approach by providing a number of safe harbour pricing guidelines (in Australia these are called "simplified record keeping options"), which if applied will not require the preparation of comprehensive transfer pricing documentation. Instead, the taxpayer must prepare sufficient documentation to evidence compliance with the safe harbour guidance (i.e. eligibility and application). This approach is considered to be pragmatic, providing certainty to taxpayers, while reducing the risk of erosion of the New Zealand tax base.

Rather than continuing the "grey area" for transfer pricing compliance, we suggest that Inland Revenue effectively sets the cost/risk analysis threshold, drawing a distinct line in the sand by implementing something similar to the suggestions above.

Transfer pricing methods

We submit that this opportunity is taken to align the transfer pricing methods referred to in legislation with those detailed in the OECD transfer pricing guidelines. Specifically, current legislation refers to the "comparable profits method", which in practice has been replaced by the OECD's "transactional net margin method".

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[8] Smaller SME companies make up the majority of New Zealand companies that would be impacted by an increase in transfer pricing documentation compliance requirements (approximately only 20 New Zealand headquartered companies qualify for Country-by-Country reporting out of 575,647 NZ Limited Companies as at 30 June 2016).

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Base Erosion and Profit-Shifting (BEPS) – Transfer Pricing and Permanent Establishment Avoidance

Introduction and general comments

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on *BEPS – Transfer Pricing and Permanent Establishment Avoidance: A Government discussion document* (discussion document).

2. The Law Society is concerned about the proposed approach to amending the effect of New Zealand's existing international treaties. We acknowledge that other countries have enacted similar rules to those proposed. Nevertheless, we consider that there is limited scope for New Zealand to enact changes in the name of 'avoidance rules' which have the effect of overruling the clear wording in our international treaties.

3. Under our treaties, foreign companies resident in countries with tax treaties that do not carry on business from a permanent establishment are afforded protection against New Zealand tax on their income from New Zealand. In return, that foreign country affords New Zealand companies the same protection.

4. It is generally accepted that the protections provided in the treaty must be subject to general rules that prevent their abuse. However, there is a line between such general rules and more specific provisions that are intended to simply undo the negotiated position reflected in the treaty. Legislation enacting this latter category is not appropriate.

5. On its own, a specific anti-avoidance rule of the type proposed may not contravene our treaty network, however the position is less clear when the entire package of proposed amendments is considered. Under the proposals, not only will foreign companies now be exposed to tax when, on the plain wording of the treaty this should not be the case, but it is also proposed that they will be subject to a different regime for the investigation and challenge of their taxes.

6. The Law Society submits that this is not in accordance with the spirit of our treaty network. It is also arguably not in accordance with the legal effect of our existing treaty network; particularly when one considers that the proposed multi-lateral instrument provides a mechanism for countries to amend their treaties to give effect to the substance of these changes.

7. Where countries choose not to amend their treaty, New Zealand should not be able to impose this change on them through our domestic rules.

Chapter 3: Permanent Establishment (PE) avoidance

8. Chapter 3 proposes to adopt a rule very similar to the ones found in the UK Diverted Profits Tax (UK DPT) and the Australian multinational anti-avoidance law (MAAL). The rules would purport to deem a permanent establishment (PE) to exist where one exists in substance despite what is documented under legal arrangements.

9. At a conceptual level, a move to a substance based test would not necessarily result in a different outcome than that arising under an appropriate application of the transfer pricing rules. New Zealand tax payable under a deemed PE should in essence be materially the same as that payable by the relevant New Zealand entity earning an appropriate margin determined under the transfer pricing rules. On this basis, the Law Society submits that there should be no need for a specific PE avoidance rule, in addition to an introduction of more robust transfer pricing rules.

10. If, nevertheless, this rule is implemented then it will be important to ensure that it is drafted so that taxpayers have a high level of certainty as to how it applies to their affairs. This is particularly important as the effect of this rule will directly impact on how easy it is to do business with New Zealand, as a foreign multi-national; and a poorly implemented rule will see New Zealand worse off.

11. The Law Society recommends that any legislation should include a provision similar in effect to section CD 22(8), which would allow taxpayers to seek specific confirmation from Inland Revenue that the PE avoidance rules do not apply to their structure. We expect a number of multi-nationals could seek to use this mechanism to give themselves certainty as to how New Zealand will tax their arrangements. We do not consider that the binding rulings regime would give the same level of comfort, given that the proposed legislation is an anti-avoidance rule.

Chapter 5: Strengthening the transfer pricing rules

Extension of time bar from four to seven years

12. The Government proposes to increase New Zealand's time bar for transfer pricing matters from four years to seven years.

13. The discussion document states in paragraph 5.69 that it can be difficult for tax authorities to adequately identify the risk, apply the arm's length principle and amend the relevant tax return within four years. However, the Law Society submits that the need to extend the time bar period should be much less relevant if the burden of proof shifts to taxpayers as proposed in paragraphs 5.43 to 5.48 of the discussion document.

14. The Government will already have access to improved information flows through:

   - master file and local file transfer pricing documentation under OECD recommendations; and
   - automatic exchanges of information between Revenue Authorities.

15. The Law Society is not convinced that it is necessary to have a bespoke limitation period for transfer pricing, particularly given the proposal to move the burden of proof to the taxpayer.

16. Further, although paragraph 5.71 specifically refers to the Government's proposal being limited to increasing New Zealand's time bar for transfer pricing matters to seven years, there are complications associated with an adjustment for transfer pricing interacting with other types such as income tax, withholding tax, etc. The Government should therefore ensure that any flow-on effect to other tax types arising from transfer pricing adjustments is carefully managed in drafting proposed legislation.

Shift of burden of proof to taxpayers

17. The Law Society submits that a longer transitional period is appropriate for any change to the burden of proof. The current proposal for the burden to shift from the first income year after enactment does not provide sufficient time for taxpayers to review their documentation in light of the changed rules.

Chapter 6: Administrative measures

Non-cooperation

18. It is proposed in Chapter 6 that non-cooperation from large multinationals could result in the proposed new administrative measures being applied (e.g. Inland Revenue issuing an assessment based on information held at the time, the imposition of fines of up to $100k for failure to comply with information requests, etc.) in order to prevent a subsidiary's non-compliance from frustrating Inland Revenue's transfer pricing investigation.

19. The Law Society submits that the factors that lead to a finding that a taxpayer is "non-cooperative" are too wide. For example, one of the factors put forward in the proposal in paragraph 6.16 of the discussion document includes "failure to respond to Inland Revenue correspondence".

20. Information required by Revenue Authorities from large organisations can be onerous and take considerable time to obtain. In practice, the Law Society also expects that where large amounts of information are requested, taxpayers will often obtain and provide information to a standard akin to that of legal discovery to avoid repetition should the investigation progress to litigation. Feedback received by the Law Society indicates it is frequently difficult to obtain the level of material required by Inland Revenue within the timeframes set, owing to an apparent lack of appreciation by Inland Revenue of the practical realities of sourcing the information requested.

21. The Law Society considers that the difficultly described above would not be unique to large multinationals and expects that delays in obtaining information are generally not driven by an unwillingness to provide information, but rather result from the timeframes required to obtain information from within large organisations.

22. The Law Society does not consider that there is sufficient basis for a standalone rule applying to transfer pricing disputes, and that the existing rules provide adequate protection for Inland Revenue.

Collection of information

23. It is proposed in paragraph 6.33 of the discussion document that the Commissioner be provided with a direct power to request information or documents that are held by or accessible to a group member that is located outside New Zealand.

24. The Law Society considers that Inland Revenue has sufficient ability to collect information from large multinationals under existing rules by virtue of country-by-country (CBC) reporting and automatic exchange of information with other Revenue Authorities. In practice, the Law Society expects that delays in obtaining information are generally a result of New Zealand being a smaller jurisdiction relative to the rest of the world. This can result in a lack of resource within multinational organisations being available to prioritise information requests relating to New Zealand.

25. The Law Society therefore considers that the introduction of specific provisions enabling Inland Revenue to directly request information or documents offshore would be unlikely to result in Inland Revenue receiving information in a timelier manner. As mentioned above, the Law Society anticipates that delays tend to be attributable to the difficulty within large organisations to obtain information requested (particularly in light of the size of New Zealand relative to other jurisdictions that multinationals operate in), rather than as a result of unwillingness by large multinationals to provide information.

26. The Law Society therefore submits that officials reconsider the proposal to increase the Commissioner's ability to collect information from multinationals, given that:

- it is unlikely that this proposal would increase Inland Revenue's ability to collect information in a more timely manner; and
- the introduction of CBC reporting rules and automatic exchanges of information.

Penalties for not providing information

27. Paragraph 6.35 of the discussion document proposes that a person may be convicted of an offence for failing to provide information held by an associated offshore group member. This would presumably apply to officers of a New Zealand subsidiary.

28. As discussed above in the context of new administrative measures for non-cooperation and wider information collection powers, New Zealand tends to be a small subsidiary in the context of large multinationals' operations. Officers and/or directors of New Zealand subsidiaries will often have little or no ability to compel offshore parent companies to provide information. The Law Society therefore considers that it would not be appropriate to impose penalties on New Zealand officers.

Requirement to pay disputed taxes early

29. It is proposed in paragraph 6.22 of the discussion document that for large multinationals engaged in particular kinds of disputes, the time at which the tax must be paid should be brought forward. The proposal is said to intend to remove any incentive for a taxpayer to prolong a dispute with Inland Revenue.

30. The reason provided in paragraph 6.21 is not compelling, given that use of money interest (UOMI) would run from the time when the tax should have been paid and penalties would apply to late payments, as it does for any other dispute. The Law Society expects that taxpayers generally do not enter into a dispute with Inland Revenue to delay the payment of tax. Instead, it is likely to be because there is a genuine dispute over the amount of tax payable.

31. It is difficult to see the justification for large multinationals in dispute with Inland Revenue to be treated differently from any other New Zealand taxpayer in this respect. The Law Society

considers the UOMI regime to be a strong enough disincentive not to prolong a dispute and is further evidenced by taxpayers using tax pooling services to mitigate UOMI.

32. We also note that section 138I of the Tax Administration Act (TAA) previously required taxpayers to pay 50% of the amount of tax being disputed, which applied for all tax disputes. This requirement was removed on 1 April 2003 as the Government felt that UOMI provided the incentive to ensure that taxpayers do not dispute an amount payable merely to delay payment. To balance the removal of the requirement to pay 50% of the disputed tax, Inland Revenue was given the power under section 138I(2B) to require payment of all the tax in dispute in those rare cases where there is a significant risk that the amount in dispute might never be paid. The Law Society considers that this power (as it was then) should remain effective where there is a real concern from Inland Revenue in respect of their ability to collect tax.

33. The discussion document also proposes in paragraph 6.24 that purchases from a tax pooling service would not be accepted as the payment of tax for the purpose of satisfying payments of disputed taxes. No justification was provided in the discussion document and it is difficult to see any justification for this limitation.

34. Based on the above, the Law Society submits that:

- there should be no need to require multinationals to pay disputed tax earlier than any other taxpayer in New Zealand; and
- the ability to use tax pooling services should continue to be available to multinationals as it is for other taxpayers in New Zealand.

Economic substance approach to transfer pricing

35. As stated in paragraph 5.2 of the discussion document, the proposed new rules would disregard legal form if it does not align with the actual economic substance of the transaction. It is foreseeable that Inland Revenue and taxpayers will continue to have different views on the relevant entities' economic substance. As such, the Law Society expects that a move to an economic substance approach is still likely to ultimately lead to dispute that would not necessarily be any different to disputes under the current legal form approach.

Application dates

36. The discussion document states that the proposed administrative rules would apply from the date of enactment of the legislation and the proposed rules for addressing the source, PE and transfer pricing issues would apply to income years beginning on or after the date of enactment. There was no comment in the discussion paper about transitional or grandfathering rules for existing structures.

37. The Law Society understands from paragraph 3.39 of the discussion document that the ultimate objective of the proposed PE avoidance rule is to discourage non-residents from entering into PE avoidance structures in the first place. However, if the proposed changes are genuinely intended to be a disincentive, officials would presumably expect a number of restructures to occur as a result of the proposed changes. Restructures, particularly in the context of large multinationals, generally take a reasonable amount of time and resources to implement.

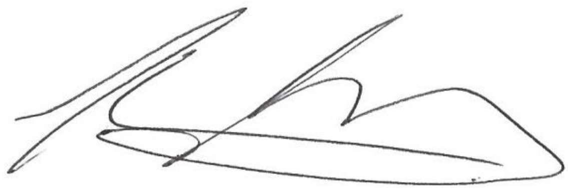
38. The Law Society therefore submits that provisions for transitional periods should be implemented alongside the proposed new rules in order to allow for large multinationals to consider their structures and implement any changes as a result of the proposed new rules.

39. Paragraph 2.22 notes that nothing in the discussion document is intended to prejudice any of the disputes or investigations that are currently being undertaken by Inland Revenue. However, the Law Society recommends that officials clarify the impact of the proposed transfer pricing rules on existing transfer pricing investigations that Inland Revenue is currently undertaking.

Conclusion

40. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully



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